No. 16,859

IN THE

United States Court of Appeals

For the Ninth Circuit

HAWAIIAN TRUST COMPANY, LIMITED, a Hawaii corporation, Trustee for the Creditors and Stockholders of PACIFIC REFINERS, LIMITED, a dissolved Hawaii corporation,

Appellant,

vs.

THE UNITED STATES OF AMERICA,

Appellee.

On Appeal from the United States District Court for the District of Hawaii.

BRIEF FOR APPELLANT

MARSHALL M. GOODSILL,
Bank of Hawaii Building,
Honolulu 1, Hawaii,
Attorney for Appellant.

ANDERSON, WRENN & JENKS,
Bank of Hawaii Building,
Honolulu 1, Hawaii,
Of Counsel.

FILED

JUL 25 1960

FRANK H. SCHMID, CLERK

Topical Index

	Page
Opinion below	1
Jurisdiction	1
Questions involved	2
Summary of argument	3
First issue	3
Second issue	4
First issue: Refiners was entitled to carry forward as a consolidated net operating loss to 1953 the net operating loss suffered in 1950 by Hilo Gas	5
Facts	5
Argument	18
A. Under the plain terms of the statute and regulations Refiners is entitled to include the Hilo Gas loss on the sale of its utility assets in its consolidated net operating loss for 1950 and to carry it forward as a consolidated net operating loss to 1953	18
B. Section 129 is not applicable because the principal purpose of the acquisition of Hilo Gas by Refiners was a business purpose, not the evasion or avoidance of taxes	23
C. If Section 129 is not applicable, Refiners and Hilo Gas cannot be denied the privilege of filing consolidated returns under Section 141	49
Second issue: Hawaii income taxes on capital gains realized in 1955 are deductible	64
Facts	64
Argument	66
A. Section 265 ("Expenses and Interest Relating to Tax Exempt Income") is not applicable because nonrecognized gains under Section 337 are not income "wholly exempt" from the income tax	66
B. Section 265 is not applicable because it disallows deductions for expenses but does not reach items deductible as taxes	79
Conclusion	85

Table of Authorities Cited

Cases

Cases	Pages
Acker, Commissioner v., ... U.S. ...., 4 L ed 2d 127 (1959)	54
Alcorn Wholesale Co., 16 T. C. 75 (1951) (A)	41
Alprosa Watch Corp., 11 T. C. 240 (1948)	41
American Pipe & Steel Corp., 25 T. C. 351 (1955), *aff'd* 243 F.2d 125 (9th Cir. 1957), cert. den. 355 U.S. 906 (1957)	44, 46, 47
Arcade Co., United States v., 203 F.2d 230, 235-236 (6th Cir. 1953)	76
Autosales Corp. v. Commissioner, 43 F.2d 931 (2d Cir. 1930)	51
Berland's, Inc., 16 T. C. 182 (1951) (A)	41, 43
Bishop Trust Company, Limited, 36 B.T.A. 1173 (1937) (A)	58, 59, 60, 62
Borg & Beck Co., 24 B.T.A. 995 (1931) (A. XI-1 Cum. Bull. 2)	82
Burnet v. Aluminum Goods Co., 287 U.S. 544 (1932)	50
Calamaro, United States v., 354 U.S. 351 (1957)	54
Chelsea Products, Inc., 16 T. C. 840 (1951), *aff'd* in part 197 F.2d 620	41
Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935), cert. den. 296 U.S. 641	63
Commercial Investment Trust Corporation, 28 B.T.A. 143 (1933), *aff'd* 74 F.2d 1015 (2d Cir. 1953)	82
Commodores Point Terminal Corp., 11 T. C. 411 (1948) (A)	25, 42, 43
Cotton States Fertilizer Co., 28 T. C. 1169 (1957)	77, 79
Court Holding Co., Commissioner v., 324 U.S. 331 (1945) ..	70, 71
Cumberland Public Services Company, United States v., 338 U.S. 451 (1950)	75, 76, 77
Curtis, James F., 3 T. C. 648 (1944)	84
David's Specialty Shops v. Johnson, 131 F.Supp. 458 (S.D. N.Y. 1955)	60
Diamond A. Cattle Co., The v. Commissioner, 233 F.2d 739 (10th Cir. 1956)	64
Dilworth Co. v. Henslee, 98 F.Supp. 957 (M.D. Tenn. 1951)	42

Pages

Elko Realty Co., 29 T. C. 1012 (1958), *aff'd* per curiam 260 F.2d 949 (3d Cir. 1958) 31, 33, 35, 37, 47, 49
Equitable Life Assur. Soc. v. Irelan, 123 F.2d 462 (9th Cir. 1941) 49

Fotopulos, United States v., 180 F.2d 631 (9th Cir. 1950) 49
Fox, John, 17 CCH Tax Ct. Mem. 1006 (1958) 50

Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956) 64
Gregory v. Helvering, 293 U.S. 465 (1935) 61, 62, 63, 64
Gypsum Co., United States v., 333 U.S. 364 (1948) 48

Halleran, B.T.A. Memo 106736, 106737 (1942), P-H B.T.A. Mem. Serv. ¶42,456 84
Hancock Construction Co., et al., 11 B.T.A. 800 (acq. 1928) 51
Heffelfinger, George W. P., 5 T. C. 985 (1945) 84
Holeproof Hosiery Co., 11 B.T.A. 547 (1928) 82

Keith, Henry P., T. C. Memo. 10883, 1 CCH Tax Ct. Mem. 184 (1942), *aff'd* on another issue 139 F.2d 596 (2d Cir. 1944) 84
Koshland v. Helvering, 298 U.S. 441 (1936) 54

Lewyt Corp. v. Commissioner, 349 U.S. 237 (1954) 37
Logan-Gregg Hardware Co., 2 B.T.A. 647 (1925) 82

Manhattan Co. v. Commissioner, 297 U.S. 129 (1936) 54
Marsman, Mary A., 18 T. C. 1 (1952) 84

Orvis v. Higgins, 180 F.2d 537 (2d Cir. 1950) 49

Pacific Coast Biscuit Corp., 32 B.T.A. 39, 42-43 (1935) (A. 1954-1 Cum. Bull. 6) 76

Reece, Commissioner of Internal Revenue v., 233 F.2d 30 (1st Cir. 1956) 54
Reinecke v. Gardner, 277 U.S. 239 (1928) 54

Smietanka v. First Trust & Savgs. Bank, 275 U.S. 602 (1922) 54
Spreckels, J. D. & A. B., Co., 41 B.T.A. 370 (1940)..55, 56, 57, 59
Stevenot v. Norberg, 210 F.2d 615 (9th Cir. 1954) 49

Pages

Stout, Joe W., 31 T. C. 1199 (No. 124) (March 1959) (A. I.R.B. 1959-48, p. 6) 83
Sun Properties v. United States, 220 F.2d 171 (5th Cir. 1955) 64

Tobacco Products Export Corporation, 18 T. C. 1100 (1952) (N.A. 1955-2 Cum. Bull. 11) 76

Virginia Metal Products, Inc., 33 T. C. ...., No. 88 (1960) 42

W A G E, Inc., 19 T. C. 249 (1952)(A) 42
Wayne Coal Mining Co., Commissioner v., 209 F.2d 152 (3d Cir. 1954) 76
Wagner, John P., 17 CCH Tax Ct. Mem. 569 (1958) 42

Statutes

Internal Revenue Code of 1939:

Section 22(b) 68
Section 23(f) 4, 21, 53
Section 24(a)(5) 77, 78, 80
Section 111(a) 53
Section 111(j)(1) 14
Section 112 68
Section 112(a) 68
Section 112(b) 68, 77
Section 112(b)(1) 68
Section 112(f) 78
Section 113(b) 53
Section 117(j) 4
Section 117(j)(1) 21
Section 117(j)(2) 21
Section 122 .... 4, 21, 22
Seciton 129 .... 4, 23, 24, 25, 37, 41, 43, 46, 47, 49, 50, 55
Section 129(a) 23
Section 141 .... 4, 22, 49, 50, 52, 54, 55
Section 141(a) 3, 18, 22
Section 141(b) 52, 54
Section 141(c) 52
Section 141(d) 18, 50, 53
Section 141(e) 19, 50

Internal Revenue Code of 1954: Pages
Section 121 69
Section 162 81
Section 164 .... 81, 82, 84
Section 164(a) 5, 66
Section 212 81
Section 265 .... 5, 65, 66, 67, 70, 75, 77, 78, 79, 80, 83, 84, 85
Section 265(1) 67, 77, 79, 80, 82, 84
Section 265(2) 80
Section 269(c) 39, 40, 43, 53
Section 332 .... 69, 71
Section 333 71
Section 337 .... 3, 5, 65, 66, 67, 69, 70, 71, 75, 76, 77, 78
Section 337(a) 66
Section 337(c)(1)(B) 70
Section 337(c)(2) 70
Section 351 69
Section 354 69
Section 361 69
Section 1031 69
Section 1032 69
Section 1033 .... 69, 77
Section 6532(a) 2
Section 7422(a) 2

Revised Laws of Hawaii 1945:
Section 4717 27
Section 4718 19
Section 8343 20

Revised Laws of Hawaii 1955:
Section 104-17 27
Section 104-18 .... 13, 19
Section 172-30 .... 13, 20

Title 28 United States Code:
Section 1291 2
Section 1294 2
Section 1340 2
Section 1346 2

Pages

United States Treasury Regulations 118, relating to Income Tax:
Section 39.129(a) 25
Section 39.141(b) 18
Section 39.141(c) 22

United States Treasury Regulations 129, relating to Consolidated Returns:
Section 24.2(b)(3) 18
Section 24.11(c) 3, 19
Section 24.13(b) 22
Section 24.13(d) 22
Section 24.31 .... 22, 55
Section 24.31(a) 22, 53, 55
Section 24.31(a)(1) 52
Section 24.31(a)(2) 52
Section 24.31(a)(3) 31, 52
Section 24.31(a)(5) 52
Section 24.31(a)(6) 52
Section 2431(b) 55
Section 24.31(b)(3) 52
Section 24.32 22

Miscellaneous

American Bar Association, 1959 Report of Section of Taxation, p. 79 41

60-2 CCH Federal Tax Reporter ¶2226 79

55 Colum. L. Rev. 37, 45 (January 1955) 71, 74

56 Colum. L. Rev. 641 (May 1956) 69

1944 Cum. Bull. 973 25

1958-1 Cum. Bull. 4 77

Federal Rules of Civil Procedure:
Rule 52(a) 48

G.C.M. 18245, 1937-1 Cum. Bull. 70 83

H. Rep. No. 704, 73d Cong., 2d Sess. 51, 75, 78, 80

H. Rep. No. 1337, 83d Cong., 2d Sess. 72, 73

Pages

I.T. 3161, 1938-1 Cum. Bull. 116 83

Mertens, Law of Federal Income Taxation:
 Section 25.128 79
 Section 38.69 ....43, 54
 Section 46.02 51
 Section 46.09 60

Montgomery, Federal Taxes 7:57 (36th ed., Ronald Press, 1955) 25

5 Moore, Federal Practice ¶52.04 (2d ed. 1953) 49

5 N.Y.U. Institute on Federal Taxation 283, 286 52

Seidman, Legislative History of Federal Income Tax Laws 1938-1861:
 Page 315 ....79, 80, 81
 Page 337 (1938) 51

S. Rep. No. 558, 73d Cong., 2d Sess. 81

S. Rep. No. 627, 78th Cong., 2d Sess. 25

S. Rep. No. 1622, 83d Cong., 2d Sess. 43, 73, 74

10 Tax L. Rev. 277, 295-296 (March 1959) 40

No. 16,859

IN THE

United States Court of Appeals

For the Ninth Circuit

HAWAIIAN TRUST COMPANY, LIMITED, a Hawaii corporation, Trustee for the Creditors and Stockholders of PACIFIC REFINERS, LIMITED, a dissolved Hawaii corporation,

Appellant,

vs.

THE UNITED STATES OF AMERICA,

Appellee.

On Appeal from the United States District Court for the District of Hawaii.

BRIEF FOR APPELLANT

OPINION BELOW

The decision of the District Court (R. 71) is reported at 178 F.Supp. 637.

JURISDICTION

This is a civil action commenced in the United States District Court for the District of Hawaii by Hawaiian Trust Company, Limited, a Hawaii corporation, as

Trustee for the Creditors and Stockholders of Pacific Refiners, Limited, a dissolved Hawaii corporation. Hawaiian Trust Company, Limited, Trustee as aforesaid, is hereinafter referred to as "taxpayer." Pacific Refiners, Limited is hereinafter referred to as "Refiners."

Taxpayer brought this action against the United States for the recovery of Internal Revenue taxes and interest alleged to have been erroneously and illegally assessed and collected. Taxpayer complied with the requirements of Sections 6532(a) and 7422(a) of the Internal Revenue Code of 1954 (and the predecessor sections of the 1939 Code), regarding suits for the recovery of any Internal Revenue tax, penalty or other sum.

The District Court had jurisdiction, regardless of the sum involved, under Title 28, U.S.C., Sections 1340 and 1346.

The District Court entered judgment dismissing the complaint on March 4, 1960. (R. 100.)

On March 11, 1960, taxpayer filed a notice of appeal. (R. 101.)

Jurisdiction is conferred on this Court by 28 U.S.C., Sections 1291 and 1294.

The pleadings necessary to show the existence of the jurisdiction are the complaint (R. 3) and the answer (R. 20).

QUESTIONS INVOLVED

Two questions are presented in this appeal, as follows:

First Issue: Whether Refiners was entitled to carry forward as a consolidated net operating loss to 1953 the net operating loss suffered in 1950 by its subsidiary, Hilo Gas Company, Limited.

Second Issue: Whether Refiners was entitled to deduct in 1955 Hawaii income taxes allocable to capital gains realized by it in 1955 but not recognized for Federal income tax purposes by reason of Section 337, Internal Revenue Code of 1954.

SUMMARY OF ARGUMENT

First Issue

Section 141(a), Internal Revenue Code of 1939, extends to an affiliated group of corporations the privilege of making a consolidated return. Refiners and Hilo Gas Company, Limited (hereinafter referred to as "Hilo Gas") became affiliated corporations prior to October 25, 1950, and met the statutory requirements for filing consolidated returns. Regulation 129, Section 24.11(c) provides that an affiliated group remains in existence as long as there is a common parent and at least one subsidiary remains affiliated with it. Accordingly, the affiliated group in this case remained in existence until Hilo Gas was dissolved in September, 1956.

A loss of $122,930.58 was sustained by Hilo Gas on the sale of its utility assets to Honolulu Gas Company, Limited (hereinafter referred to as "Honolulu Gas") on October 31, 1950. This loss took place on that date and not at any other time. This loss took place *after*

affiliation with Refiners. The loss was an ordinary loss. Consequently, under the Code (Sections 23(f), 117(j), 122 and 141 of the Internal Revenue Code of 1939), the income tax regulations and the consolidated return regulations, Hilo Gas was entitled to a deduction for this loss, and Refiners was entitled to include this loss in its consolidated net operating loss for 1950 and to carry it forward in full as a consolidated net operating loss carry-over to 1953.

Refiners acquired control of Hilo Gas for the purpose of obtaining an assured market in Hilo for butane to be manufactured in Refiners' new plant. There is no evidence to support the conclusion of the District Court (R. 98) that the principal purpose of the acquisition of Hilo Gas by Refiners was the evasion or avoidance of Federal income tax within the meaning of Section 129, Internal Revenue Code of 1939. The stipulated facts are that the principal purpose of the acquisition was a business purpose, unrelated to tax considerations.

Since Section 129 is not applicable and since there was a business purpose for the acquisition, the privilege of filing consolidated returns and carrying forward the net operating loss, which is granted by the plain terms of the statute and the regulations, cannot be denied to this taxpayer.

Second Issue

Hawaii income taxes allocable to gains realized by Refiners in 1955 on sale of its assets in accordance with its plan of liquidation, which gain was not recog-

nized for Federal income tax purposes by reason of Section 337, Internal Revenue Code of 1954, are deductible in full by Refiners under Section 164(a), Internal Revenue Code of 1954. Section 265 ("Expenses and Interest Relating to Tax Exempt Income") is not applicable because (1) non-recognized gains under Section 337 are not "income wholly exempt from taxes" and (2) this section disallows deductions for *expenses* but does not reach items deductible as *taxes.*

FIRST ISSUE: REFINERS WAS ENTITLED TO CARRY FORWARD AS A CONSOLIDATED NET OPERATING LOSS TO 1953 THE NET OPERATING LOSS SUFFERED IN 1950 BY HILO GAS.

FACTS

The facts in this case have all been stipulated by the parties. The Stipulation of Facts is printed in the Record at pages 25 to 52.

Refiners was organized as a corporation under the laws of the Territory of Hawaii on May 31, 1949. Refiners was dissolved on November 19, 1956, and Hawaiian Trust Company, Limited (taxpayer) was appointed Trustee for the creditors and stockholders in accordance with the laws of Hawaii. (Paragraph I, Stipulation of Facts, R. 25.)

Refiners' principal business was the manufacture and sale of petroleum products and the distribution of butane (a form of liquefied petroleum gas) in the Territory of Hawaii. Refiners was not a public utility, and none of its business was subject to regulation by the Public Utilities Commission of Hawaii. Refiners

entered into an oil and butane contract with Standard Oil of California (hereinafter called "Standard") in August of 1949 for a period of ten years for the purchase of petroleum oil and butane. The butane was blended by Standard into heavy gas oil and shipped to Refiners in Honolulu. Refiners at its refinery in Honolulu separated the butane from the gas oil. The butane thus obtained was liquefied and stored by Refiners in pressure tanks, ready for distribution and sale. The butane-free gas oil was then passed through a further process which removed diesel oil and similar fractions contained in the original oil, leaving asphalt. The gas oil was then sold to Honolulu Gas for its use in the manufacture of gas. Under this contract with Standard, Refiners was required to purchase a substantial minimum amount of heavy gas oil blended with butane. For the first contract year the minimum amounts were 450,000 barrels of oil and 650,000 gallons of butane; for the second year the minimum amounts were 500,000 barrels of oil and 1,450,000 gallons of butane; for each contract year thereafter the minimum amounts were 500,000 barrels of oil and 1,700,000 gallons of butane. The Hilo Gas distribution system, after its conversion to butane air in 1951, used in excess of 500,000 gallons of butane annually, accounting for about one-third of the total butane sales of Refiners. (Paragraph III, Stipulation of Facts, R. 27-28.)

Hilo Gas was organized as a corporation under the laws of Hawaii in 1927. It engaged in the business of manufacturing gas from oil and distributing it through gas mains in the City of Hilo, Island of Hawaii. It was a public utility subject to regulation

by the Public Utilities Commission. In 1948 and 1949 the Company lost money and was in financial difficulty. In the spring of 1950 Mr. A. E. Englebright, who was then the general manager of Refiners, was approached by Mr. Orlando Lyman, the president and largest stockholder of Hilo Gas, for assistance in solving the problems of Hilo Gas. The proposition was made that Hilo Gas cease the manufacture of gas from oil and buy butane from Refiners, which Hilo Gas would then distribute through its gas mains in the City of Hilo as a public utility. This would save manufacturing costs and reduce gas rates to a point where they might be competitive with electric rates. The minutes of the Executive Committee of Refiners for May 10, 1950 state:

> "The General Manager and the Secretary reviewed the findings of their recent trip to Hawaii taken for the purpose of determining the best outlet for butane on that island. It was reported that the Hilo Gas Company wished to enter into an arrangement whereby they would convert their manufactured gas facilities to a butane-air or butane-vapor operation and that, in conjunction with this, they wished to obtain a franchise for the distribution of butane throughout the entire Island of Hawaii."

The feasibility of the Hilo Gas plan depended to some extent on the condition of its gas mains. Mr. Englebright sent Mr. L. L. Gowans, chief engineer of Honolulu Gas, to Hilo to make a survey. Mr. Gowans made a report, dated June 14, 1950, which concluded that the gas mains were in adequate condition and that it

would be entirely feasible and desirable to distribute a butane air mix in the Hilo Gas distribution system without too great a loss in leakage. After these reports and conversations with the principals, Refiners, on August 7, 1950, made a proposal to Mr. Lyman that it supply Hilo Gas with butane at 16¢ per gallon, based on the present posted price of butane in San Francisco. Refiners would also provide equipment and appurtenances for butane air installation at the Hilo plant at a cost of approximately $25,000, to be repaid by Hilo Gas through an additional 1¢ per gallon payment for all butane used in its system. Mr. Lyman expressed interest in this proposal, but in addition wished to acquire the franchise for distribution of "Isle-Gas" (Refiners' trade name for butane which it distributed in tanks or containers for use by rural customers) throughout the Island of Hawaii at the price quoted for use in the Hilo Gas mains. On August 31, 1950 Mr. Englebright wrote Mr. Lyman that Refiners could not "go along" with his proposal to include the North Hilo and Puna districts with Hilo proper for a combination utility and non-utility operation, with butane to be supplied at the price which Refiners had proposed for the Hilo Gas mains only. He said that Refiners was prepared to go ahead with the conversion proposal stated in the letter of August 7, but that it could not guarantee that Isle-Gas installations (which would be handled by other parties) would not compete directly with Hilo Gas service. This might be serious, said Mr. Englebright, as the cooking load (the only profitable load of Hilo Gas)

could be served more cheaply with Isle-Gas than with gas from the mains of Hilo Gas. Mr. Englebright suggested that it might be wisest for Hilo Gas to discontinue operations as a public utility (that is, distribution of gas through city gas mains) and instead convert all appliances of its customers to a butane-vapor operation, hooking them up to butane tanks (Isle Gas). He said that he thought that this would cost about $125,000, but would be a successful operation. This alternative proposal was not acceptable to Mr. Lyman. However, about the middle of September, 1950, Mr. Lyman offered to sell his stock in Hilo Gas to Refiners or to Honolulu Gas. With the exception of the foregoing negotiations with Refiners, neither Mr. Lyman nor any other of the stockholders or management of Hilo Gas had any plans for renovation or conversion of the Hilo Gas system or the abandonment or scrapping of the manufactured gas plant. (Paragraph IV, Stipulation of Facts, R. 29-31.)

On September 16, 1950 the Executive Committee of Refiners met to consider Mr. Lyman's proposal. The minutes of this meeting state:

> "The manager stated that we have been approached by the majority stockholder [Mr. Lyman] of the Hilo Gas Company with the proposal that he dispose to us his holdings of that Company, at a price that appeared to be advantageous from our standpoint. Another stockholder [Mr. Hutchinson] has slightly less than 30% of the balance of shares of Hilo Gas Company and it seems likely that they could be obtained for a reasonable price."

Mr. Englebright reviewed the advantages of the purchase of the Hilo Gas stock to provide an assured outlet for butane on the Island of Hawaii. He stated that in view of Refiners' commitment to Standard to purchase minimum amounts of butane, it was necessary or highly desirable to obtain this Hilo outlet, plus the non-utility business of Hilo Gas—the distribution of liquefied petroleum gas (called "Rock Gas") in tanks to rural customers beyond the city gas mains. Also, Refiners' new refinery was scheduled for completion in the fall of 1950 (actually completed in December), and it was necessary to find outlets for its butane production. Mr. Englebright stated that unless an attempt was made to perpetuate Hilo Gas, it would probably be dissolved (particularly as certain of its stockholders were also interested in the Hilo Electric Company), and this would serve as an obstacle to expanding gas sales, not only in Hilo, but also in other parts of the Island of Hawaii. Purchase of the stock would also assure Refiners of control of the non-utility ("Rock Gas"[1]) business of Hilo Gas in the outlying districts of the Island of Hawaii. Another meeting of the Executive Committee of Refiners was held on September 26, 1950, at which the Hilo Gas situation was discussed. On October 3, 1950 an option was obtained by Refiners from Mr. Lyman granting to Refiners an option to purchase his shares for $35,000 for a period of seven days from the date of the option, subject to the condition that the purchaser obtain options to pur-

[1] "Rock Gas" was the trade name for the liquefied petroleum gas distributed by Hilo Gas. It was substantially similar to and competitive with Refiners' product known as "Isle Gas".

chase not less than 75% of each of the outstanding classes of stock of Hilo Gas. There were 2,283 shares of 8% preferred stock, 1,929 shares of 7% preferred stock and no common stock outstanding. Both the 8% preferred stock and the 7% preferred stock were voting shares. Mr. Lyman owned 1,431 shares of the 8% preferred stock and 865 shares of the 7% preferred stock. Also on October 3, 1950, Refiners obtained a similar option from Mr. Hutchinson, who owned 747 shares of 8% preferred stock and 492 shares of 7% preferred stock, for a price of $18,832.80. On October 5, 1950 the Board of Directors of Refiners authorized the purchase by it of all of the stock of Hilo Gas. (Paragraph V, Stipulation of Facts, R. 31-34.)

The Hilo Gas stock was purchased by Refiners, rather than by Honolulu Gas, because Refiners, as the distributor of butane, had the primary interest in securing the Hilo market. On August 31, 1950 Mr. Englebright had recommended to Mr. Lyman that, as other solutions had failed, Hilo Gas should discontinue the distribution of gas through mains and distribute butane in tanks to customers. This would have resulted in a non-utility business of no interest to Honolulu Gas, but would have left Hilo Gas as a large butane customer of Refiners. Also, Refiners wished to acquire the non-utility "Rock Gas" business of Hilo Gas in outlying districts on the Island of Hawaii. Another reason for the purchase of the stock by Refiners, rather than by Honolulu Gas, was that an order of the Public Utilities Commission would have been necessary before Honolulu Gas could act to purchase the

stock, whereas no such order was required in the case of Refiners, which was not a public utility, and it was the view of the management of Refiners that quick action was necessary. Further, the purchase of Hilo Gas stock by Honolulu Gas would have made the latter company a public utility holding company under Federal law, a situation which Honolulu Gas wished to avoid. (Paragraph VI, Stipulation of Facts, R. 34-35.)

The stock of Messrs. Lyman and Hutchinson was sold to Refiners on October 6, 1950. At about the same time Refiners also purchased the largest blocks of stock held by other stockholders. On October 21, 1950 a letter was sent to the remaining stockholders of Hilo Gas offering to purchase their shares at the same price, and pursuant to this offer, Refiners purchased before October 25 most of the outstanding shares of both classes held by minority stockholders. Prior to October 25, 1950 Refiners had acquired 95% or more of the outstanding capital stock of Hilo Gas. Refiners never acquired more than 1,872 of the 1,929 outstanding shares of the 7% preferred stock of Hilo Gas and did not acquire the last minority-owned share of the 8% preferred stock until shortly before the dissolution of Hilo Gas in September, 1956. The total cost to Refiners of the Hilo Gas stock purchased by it was $63,897.20. (Paragraph VII, Stipulation of Facts, R. 35-36.)

Under the Hawaii law, no public utility may sell, lease, assign, mortgage or otherwise dispose of or encumber the whole or any part of its road, line, plant system or other property necessary or useful

in the performance of its duties to the public without first having secured from the Public Utilities Commission an order authorizing it to do so, and every such sale, lease, assignment, mortgage, disposition or encumbrance made other than in accordance with the order of the Commission shall be void. (Sec. 104-18, RLH 1955.) On October 20, 1950 Hilo Gas filed a petition with the Public Utilities Commission in which it recited that it proposed to sell all of its assets, except its merchandise, goods, notes and accounts receivable related to the appliance sales business and its liquefied petroleum gas business, to Honolulu Gas for approximately $60,000, the exact price to be determined at its meeting of stockholders called to approve of such sale. The hearing on this application was held on October 26, 1950, at which the applicant presented its case. The Commission issued an order dated October 26, 1950, which was filed November 15, 1950, authorizing Hilo Gas to sell its utility assets to Honolulu Gas for a total consideration of approximately $64,000, consisting of a cash payment of approximately $46,000 and the assumption by the purchaser of outstanding utility liabilities in the amount of approximately $18,000. (Paragraph VIII, Stipulation of Facts, R. 36-37.)

Under the Hawaii law, the sale of substantially all of the property of a corporation requires the affirmative vote of three-fourths of all stock issued and outstanding and having voting power. (Sec. 172-30, RLH 1955.) At a meeting held October 31, 1950 the stockholders of Hilo Gas, by the necessary vote, authorized

the sale of the utility assets of the Company to Honolulu Gas and the sale of the appliance and liquefied petroleum gas business and assets to Refiners. On October 31, 1950 Hilo Gas executed a bill of sale transferring to Refiners for $18,500 the merchandise, bottled gas and gas appliances and the notes and accounts receivable relating to the appliance sales business and the liquefied petroleum gas business. On October 31, 1950 Hilo Gas and Honolulu Gas executed an instrument whereby Hilo Gas conveyed to Honolulu Gas for $46,000 its utility manufacturing plant and equipment, its distribution system and utility assets, and Honolulu Gas assumed the liabilities of Hilo Gas. Possession of these assets was not taken by the purchasers until after October 31, 1950. (Paragraph IX, Stipulation of Facts, R. 37.)

On October 31, 1950, Hilo Gas sold utility assets to Honolulu Gas for $122,930.58 less than their net book value. Said utility assets sold to Honolulu Gas consisted of "property used in the trade or business" as defined in Section 111(j)(1), Internal Revenue Code of 1939. (Paragraph X, Stipulation of Facts, R. 37-38.)

After the Public Utilities Commission approved the sale of the utility assets of Hilo Gas to Honolulu Gas, the necessary facilities for converting the Hilo system to butane air were ordered. The conversion of the system was completed in March of 1951, and on April 1, 1951 butane air gas was first supplied to the City of Hilo. Until April 1, 1951 all of the gas furnished to the City of Hilo was manufactured in the old plant

of Hilo Gas. The old plant was retained as a stand-by facility for a month or so after April 1, 1951 until it could be ascertained that the butane air system was operating properly. Thereafter, such of the manufacturing facilities of the old plant as were not used in the butane air system were abandoned, scrapped or transferred to the Honolulu Division of Honolulu Gas. The gas mains and distribution system of Hilo Gas were continued in use by Honolulu Gas. Hilo Gas had never claimed an obsolescence or abandonment loss for tax purposes on any of the utility assets sold by it to Honolulu Gas on October 31, 1950. (Paragraph XI, Stipulation of Facts, R. 38-40.)

As a result of the sale of said utility assets to Honolulu Gas for $122,930.58 less than their net book value, Hilo Gas claimed a net operating loss of $117,792.57 for 1950. (Paragraph XII, Stipulation of Facts, R. 40.)

The taxable year of both Refiners and Hilo Gas was the calendar year. Refiners and Hilo Gas filed consolidated Federal income tax returns for the years 1950, 1951, 1952 and 1953. Refiners and Hilo Gas filed separate returns for the years 1954 and 1955. Both companies filed separate Territorial income tax returns for the years 1950-1955 inclusive. (Paragraph XIII, Stipulation of Facts, R. 40.)

In the year 1950 Refiners suffered a loss of $93,092. In 1951 it had a net income of $17,445 and in 1952 $39,147. It did not have to pay any Federal or Territorial income taxes in those years. In 1953 it had a

net income before income taxes of $206,397.20 and after income taxes (as reported) of $167,229. In 1954 it had a net income before income taxes of $215,735.66 and after income taxes (as reported) of $104,977. All of the foregoing figures are on an unconsolidated basis. (Paragraph XIV, Stipulation of Facts, R. 40-41.)

At the time of the acquisition of the stock of Messrs. Lyman and Hutchinson on October 6, 1950, no consideration was given by Refiners to the tax aspect of the transaction. The officials of Refiners did not know what the book value of the Hilo Gas assets was, and the Hilo Gas books were not made available to Refiners until after the decision had been made to purchase the Lyman and Hutchinson stock. Mr. Lyman has stated that the principal purpose on taking over Hilo Gas was to sell butane not then used by Hilo Gas.

> "As far as I know no investigation was made into the accumulated losses of Hilo Gas or was the matter discussed at any time between Mr. Englebright and myself during the negotiations. The purpose of the purchase of Hilo Gas Co. was to do away with the old manufactured gas plant and replace it with Butane shipped in from Pacific Refiners." (Letter of August 27, 1956.)
>
> "Mr. Englebright and I at no time discussed the book value of the assets of Hilo Gas Company.
>
> "It is also my recollection that your accounting staff did not arrive in Hilo until the day I left the company after the sale. This timing I recollect as pay for my vacation time was left up to your staff. They refused payment. This incident, I be-

lieve, helps to place the correct timing of your accountant's access to the books. Mr. Englebright did not look over the books at any time before the purchase." (Letter of September 17, 1956.)

(Paragraph XVI, Stipulation of Facts, R. 41-42.)

It was not until November, 1950, that Refiners obtained advice on the tax aspects of the transaction. Mr. J. C. Rosebrook, the Treasurer of Refiners, consulted with Mr. H. C. Dunn, of Cameron, Tennent and Greaney, who wrote an opinion dated November 15, 1950 pointing out that the loss on the sale to Honolulu Gas would be an allowable deduction in a consolidated return filed by Refiners and Hilo Gas, but that this would not be an immediate benefit because Refiners did not have any net income. (Paragraph XVII, Stipulation of Facts, R. 42-43.)

Refiners included the net loss from the sale in October, 1950, of the utility assets of Hilo Gas to Honolulu Gas in computing the net operating loss carryover to subsequent years, in the consolidated income tax returns timely filed for Refiners and Hilo Gas. The Commissioner of Internal Revenue disallowed this item, resulting in a deficiency for the year 1953 of $58,472.39, plus interest of $11,301.99, which taxpayer has paid and is suing to recover. (Paragraphs XXII and XXIII, Stipulation of Facts, R. 46-48.)

ARGUMENT.

A. UNDER THE PLAIN TERMS OF THE STATUTE AND REGULATIONS REFINERS IS ENTITLED TO INCLUDE THE HILO GAS LOSS ON THE SALE OF ITS UTILITY ASSETS IN ITS CONSOLIDATED NET OPERATING LOSS FOR 1950 AND TO CARRY IT FORWARD AS A CONSOLIDATED NET OPERATING LOSS TO 1953.

Section 141(a), Internal Revenue Code of 1939,[2] extends to an affiliated group of corporations the privilege of making a consolidated return:

> "An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns."

Section 141(d) defines an "affiliated group" as one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if the parent owns stock possessing at least 95% of the voting power of all classes of stock of the subsidiary. An "affiliated group" is formed at the time that the common parent corporation becomes the owner directly of stock possessing at least 95% of the voting power of another includible corporation.[3]

---

[2]As the tax year involved in this issue is 1953, the 1939 Code is applicable rather than the 1954 Code. References in this section of the brief are, therefore, to the 1939 Code unless otherwise indicated.

[3]Income Tax Regulations 118, Section 39.141-1(b); Consolidated Return Regulations 129, Section 24.2(b)(3). The latter are reproduced at paragraph 58,201, CCH *Excess Profits Tax Reporter*, 3d ed.

Section 141(e) defines an includible corporation as any corporation except an exempt corporation and others, none of which exemptions or exceptions are applicable here.

Refiners and Hilo Gas became affiliated corporations prior to October 25, 1950 and met the statutory requirements for filing consolidated returns. There were two classes of voting stock of Hilo Gas—7% preferred and 8% preferred. Refiners purchased the stock of the two largest stockholders (Messrs. Lyman and Hutchinson) on October 6, 1950 and purchased the largest blocks of stock held by others at about the same time. Prior to October 25, 1950 Refiners had acquired more than 95% of the outstanding capital stock of Hilo Gas. (Paragraph VII, Stipulation of Facts, R. 35-36.)

Regulations 129, Section 24.11 (c) provides that an affiliated group of corporations remains in existence as long as there is a common parent and at least one subsidiary remains affiliated with it. Accordingly, the affiliated group in this case remained in existence until Hilo Gas was dissolved in September, 1956.

On October 31, 1950 Hilo Gas sold its utility assets to Honolulu Gas. Under the law of Hawaii this sale required the approval of the Hawaii Public Utilities Commission[4] and the approval of three-fourths of the

---

[4]Section 104-18, Revised Laws of Hawaii 1955 (Section 4718, RLH 1945):

"*Merger and consolidation of public utility corporations.* No public utility corporation shall sell, lease, assign, mortgage

stockholders of Hilo Gas.[5] The approval of the Public Utilities Commission was obtained on November 26, 1950 and the necessary vote of the stockholders was obtained on October 31, 1950. The instrument conveying the utility assets to Honolulu Gas was executed and dated October 31, 1950. Under the law, the sale could not have taken place earlier. The sale took place *after* Hilo Gas and Refiners became "affiliated corporations" by reason of the acquisition of 95% of the Hilo Gas voting stock by Refiners sometime before

---

or otherwise dispose of or encumber the whole or any part of its road, line, plant, system or other property necessary or useful in the performance of its duties to the public, or any franchise or permit, or any right thereunder, nor by any means whatsoever, directly or indirectly, merge or consolidate with any other public utility corporation without *first* having secured from the commission an order authorizing it so to do. Every such sale, lease, assignment, mortgage, disposition, encumbrance, merger or consolidation, made other than in accordance with the order of the commission shall be *void.*" (Emphasis added.)

[5]Section 172-30, Revised Laws of Hawaii 1955 (Section 8343, RLH 1945):

"*Voluntary transfer of corporate assets; notice to stockholders.* A voluntary sale, lease or exchange of all or substantially all of the property and assets of any domestic corporation including its good will, may be authorized by it upon such terms and conditions and for such consideration (which may be in whole or in part shares of stock in or other securities of, any other corporation or corporations, domestic or foreign) as its board of directors deems expedient, and for the best interests of the corporation, when and as authorized or approved by the affirmative vote or consent of the holders of not less than three-fourths of all stock issued and outstanding and having voting power or if it be a non-stock corporation, the affirmative vote or consent of three-fourths of its members. * * *

"* * * If the corporation is a public utility company within the meaning of chapter 104, such action shall require the prior approval of the public utilities commission, to be evidenced by a certificate of approval filed with the corporation."

October 25, 1950. (Paragraphs VII, VIII and IX, Stipulation of Facts, R. 35-37.)

Hilo Gas sold its utility assets to Honolulu Gas on October 31, 1950 for $122,930.58 *less* than their tax basis, resulting in a loss to Hilo Gas in this amount. This was a closed and completed transaction at that time. The gain or loss from the sale or other disposition of property is required to be recognized by Section 111. These assets (buildings and improvements, manufacturing plant and equipment, distribution system and related facilities) consisted of "property used in the trade or business" as defined in Section 117(j)(1). (Paragraph X, Stipulation of Facts, R. 37-38.) The loss suffered by Hilo Gas was an ordinary loss. Section 117(j)(2) provides that if gains upon sales or exchanges of property used in the trade or business do *not* exceed losses from such sales or exchanges, such losses shall *not* be considered as losses from the sale of capital assets—in other words the losses are ordinary losses. Section 23(f) allows a corporation a deduction for losses sustained during the taxable year. Section 122 provides for the computation and carry over of a net operating loss. Under these sections Hilo Gas had a net operating loss for 1950 of $117,792.57 (Paragraph XII, Stipulation of Facts, R. 40) which, after adjustment for small intervening profits of Hilo Gas, resulted in a net operating loss carry over to 1953 of $116,405.64. (Paragraph XXII, Stipulation of Facts, R. 46-48.)

Refiners and Hilo Gas filed consolidated income tax returns for the years 1950 to 1953, inclusive. (Para-

graph XXIII, Stipulation of Facts, R. 48.) In case a corporation is a member of an affiliated group for a fractional part of a year, the consolidated return shall include the income (or loss) of such corporation for the part of the year during which it is a member of the group. Section 141(a), last sentence; Reg. 118, Section 39.141-1(c); Reg. 129, Section 24.13(b) and (d); Reg. 129, Section 24.32. Under Reg. 129, Sec. 24.31(a), the consolidated net operating loss deduction for the affiliated group must be computed by combining the net operating losses of the several affiliated corporations having net operating losses, including carry overs and carry backs. Thus, the consolidated returns filed for Refiners and Hilo Gas for 1950 properly included the loss suffered by Hilo Gas *after* the affiliation. Under Sections 122 and 141 of the Code and the Consolidated Return Regulations (Section 24.31), Refiners was entitled to carry the 1950 consolidated net operating loss forward to 1953, which was the first year in which there were sufficient consolidated profits to absorb the loss. (Paragraphs XIV and XV, Stipulation of Facts, R. 40-41.)

The loss which was incurred and recognized when Hilo Gas sold its utility assets to Honolulu Gas for a price less than their tax basis is a net operating loss sustained by Hilo Gas. Under the plain terms of the foregoing provisions of the statute and regulations, the Hilo Gas net operating loss in 1950 can be carried forward by Refiners in consolidated returns to the year 1953. Indeed, the Government has never suggested that the loss carry forward did not come within

the literal terms of the statute and the regulations, nor did the District Court make any such finding. Indeed, it is implicit in the District Court's decision that *despite* the fact that the taxpayer and Hilo Gas fall within the loss recognition, carry forward, and consolidated return provisions, nevertheless the loss carry forward may be denied because of the collateral considerations, primarily the applicability of Section 129. (R. 86.)

B. SECTION 129 IS NOT APPLICABLE BECAUSE THE PRINCIPAL PURPOSE OF THE ACQUISITION OF HILO GAS BY REFINERS WAS A BUSINESS PURPOSE, NOT THE EVASION OR AVOIDANCE OF TAXES.

The decision of the District Court denying the loss carry forward is based primarily on the conclusion that "Refiners has not established that the principal purpose for the acquisition of Hilo Gas was not for evasion or avoidance of Federal income tax," within the meaning of Section 129, Internal Revenue Code of 1939.

Section 129 provides:

> "(a) *Disallowance of Deduction, Credit, or Allowance.*—If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation * * * and the *principal purpose* for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such

> person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed." (Emphasis added.)

We think it is apparent from a reading of the Stipulation of Facts in this case that the District Court erred in reaching this conclusion. It would be difficult to find a case where the business purpose is more clearly established than here or where there was less of a tax evasion or avoidance purpose. The facts are all stipulated. There is no conflict in the evidence. There is no evidence at all to support the District Court's conclusion that the principal purpose of the acquisition was tax evasion or avoidance. The District Court's conclusion flies in the face of the stipulation of the parties that "at the time of the acquisition of the stock of Messrs. Lyman and Hutchinson [the controlling stock of Hilo Gas] on October 6, 1950 no consideration was given by Refiners to the tax aspects of the transaction." (Paragraph XVI, Stipulation of Facts, R. 41-42.) The evidence, and it is affirmative evidence not merely negative evidence, or the absence of evidence, establishes that the purpose of the acquisition was a business purpose.

Section 129 takes effect only if *the principal purpose* for which the acquisition was made is the evasion or avoidance of Federal income or excess profits taxes. The statute says this about as clearly as a statute can say anything. The Regulations say so: "*The principal purpose* for which the acquisition was made *must* have been the evasion or avoidance of Federal

income or excess profits tax." (Emphasis added.) Reg. 118, Section 39.129-3(a). The Senate Committee Report makes it even clearer: "The House bill made Section 129 operative if *one* of the principal purposes was tax avoidance. Your committee believes that the Section should be operative *only* if the evasion or avoidance *outranks,* or *exceeds in importance,* any other one purpose." (Emphasis added.) S. Rep. No. 627, 78th Cong., 1st Sess., pp. 59-60; 1944 *Cum. Bull.* 973, at p. 1017. This point has been specifically considered by the Tax Court which has held that: "The tax avoidance purpose must exceed in importance any other purpose to constitute the 'principal purpose.'" *Commodores Point Terminal Corp.,* 11 T.C. 411, 418 (1948)(A). A leading tax textbook states:

> "For the provision to apply, the *principal* purpose of the acquisition must be to secure to the acquiring corporation a benefit from the use of a tax deduction, credit, or allowance which it would not otherwise enjoy. Moreover, even if there is a tax-saving motive, the prohibitions do not apply, so long as the principal purpose is a legitimate business one. A taxpayer is not expected to shun a legitimate and profitable business transaction because an incidental result would be a substantial tax saving." (Emphasis added.) *Montgomery, Federal Taxes* 7:57 (36th ed., Ronald Press, 1955).

What was the principal purpose of the acquisition of control of Hilo Gas by Refiners? To obtain a market for the butane to be produced in Refiners' new plant, construction of which was completed in December,

1950. Under its contract with Standard Oil Company, Refiners was required to purchase a very substantial minimum amount of crude oil blended with butane: for the first year, 450,000 barrels of oil and 650,000 gallons of butane; for the second year, 500,000 barrels of oil and 1,450,000 gallons of butane; for each of the eight years thereafter, 500,000 barrels of oil and 1,700,000 gallons of butane. Refiners ascertained that it was feasible to convert the manufactured gas distribution system of Hilo Gas to butane air, which would make Hilo Gas a very large butane customer. The Hilo Gas distribution system, after its conversion to butane air in 1951, used in excess of 500,000 gallons of butane annually, accounting for about one-third of the total butane sales of Refiners. In presenting the matter of the acquisition of Hilo Gas to his Board of Directors on September 16, 1950, Mr. Englebright (manager of Refiners) reviewed the advantages of the purchase of the Hilo Gas stock to provide an assured outlet for butane on Hawaii. He stated that in view of Refiners' commitment to Standard to purchase minimum amounts of butane, it was necessary or highly desirable to obtain this Hilo outlet, plus the non-utility business of Hilo Gas—the distribution of liquefied petroleum gas ("Rock Gas") in tanks to rural customers beyond the city gas mains. Also Refiners' new plant was scheduled for completion that fall and needed an outlet for butane production. Unless an attempt were made to perpetuate Hilo Gas, it would probably be dissolved and this would serve as an obstacle to expanding gas sales in Hilo and

other parts of the Island of Hawaii. All these facts are stipulated. (Paragraphs III, IV and V, Stipulation of Facts, R. 27-34.)

The reasons why Hilo Gas was acquired by Refiners rather than by Honolulu Gas are because, Refiners, as the distributor of butane, had the primary interest in securing the Hilo market (Mr. Englebright had even suggested at one point in the negotiations that Hilo Gas give up its utility business and supply its customers with butane in tanks supplied by Refiners, which would have resulted in a non-utility business of no interest to Honolulu Gas); because Refiners wished to acquire the non-utility "Rock Gas" business in rural districts on the Island of Hawaii; because an order of the Public Utilities Commission would have been necessary before Honolulu Gas could act to purchase the stock whereas no such order was required in the case of Refiners which was not a public utility[6] and quick action was necessary; because the purchase of Hilo Gas stock by Honolulu Gas would have made

---

[6]Section 104-17, Revised Laws of Hawaii, 1955 (Section 4717 RLH 1945) provides:

"§104-17. *Acquirement of stock of another public utility.* No public utility corporation shall purchase or acquire, take or hold, any part of the capital stock of any other public utility corporation, organized or existing under or by virtue of the laws of the Territory, without having been first authorized to do so by the order of the commission. Every assignment, transfer, contract or agreement for assignment or transfer of any stock by or through any person or corporation to any corporation or otherwise in violation of this section shall be void and of no effect; and no such transfer shall be made on the books of any public utility. Nothing herein contained shall be construed to make illegal the holding of stock lawfully acquired before July 1, 1933."

the latter a public utility holding company under Federal law, a situation which Honolulu Gas wished to avoid. (Paragraph VI, Stipulation of Facts, R. 34-35.)

It has also been stipulated that at the time of the acquisition of the controlling interest (stock of Messrs. Lyman and Hutchinson) in Hilo Gas no consideration was given by Refiners to the tax aspects of the transaction; that the officials of Refiners did not then know what the book value of the Hilo Gas assets was; that the Hilo Gas books were not made available to Refiners until *after* the decision had been made to purchase the controlling stock interest. (Paragraph XVI, Stipulation of Facts, R. 41-42.)

Refiners was prepared to and did purchase the Hilo Gas stock without knowing or caring whether subsequent sales of Hilo Gas utility assets would result in a gain or loss to Hilo Gas. Refiners did not consider the tax aspects of the transaction until November, 1950, the month *after* it had acquired control of Hilo Gas. (Paragraph XVII, Stipulation of Facts, R. 42-43.) The acquisition of Hilo Gas was not a transaction motivated by tax considerations; rather it was a transaction motivated by business considerations where taxes were not even considered until *after* the transaction was completed. Any tax benefit to Refiners which might result from the transaction was an afterthought, an unanticipated windfall.

If the principal purpose of the acquisition had been tax evasion or avoidance Refiners would have made it a condition of its agreement to purchase the Lyman

and Hutchinson stock that it be able to acquire 95% of the outstanding stock of each class, that being the amount required for it to file consolidated returns and to use any Hilo Gas loss suffered after the affiliation. However, Refiners made no such condition and agreed to buy the Lyman and Hutchinson stock without knowing whether it could acquire 95% of all the stock. The requirement that Refiners obtain 75% of the stock was a condition of the seven day option imposed by Lyman, not Refiners. (Paragraph V, Stipulation of Facts, R. 31-34.) Refiners bought and paid for the Lyman and Hutchinson stock on October 6, 1950, this being about 75% of the total of each class, but it was not until after its letter to the other stockholders dated October 21, 1950, that Refiners acquired enough additional stock to bring its total above 95%. (Paragraphs V and VII, Stipulation of Facts, R. 31-34; 35-36.) If this was in fact a "tax scheme" it is extremely odd that Refiners would have paid out $53,832 to Lyman and Hutchinson without having any assurance that it could get enough of the balance of the stock to complete the scheme.

In 1950, Refiners had a loss of $93,092. In 1951, it had a before-tax income of $17,445 and in 1952 a before-tax income of $39,147. Because of its own 1950 loss carry-over it had no income taxes to pay until 1953. (Paragraph XIV, Stipulation of Facts, R. 40-41.) In October, 1950 the future of Refiners was, at best, highly speculative. It is hardly likely that Refiners would have spent any money buying Hilo Gas stock for the purpose of acquiring an operating

loss carry forward. It had almost a $100,000 loss already and no offsetting income. It needed to acquire operating income, not further operating losses. If the corporate officials involved had considered the tax aspects of the transaction or possible tax benefits, it seems obvious that they would have recommended that the acquisition be by Honolulu Gas, an established, profitable business which could use an operating loss, rather than by Refiners. For example, Honolulu Gas might have acquired 95% of the stock of Hilo Gas and filed consolidated returns; during the consolidated return period Hilo Gas could have sold, abandoned or taken obsolescence losses on portions of the manufactured gas plant and Honolulu Gas could have immediately used such losses against its income. Under the circumstances, the acquisition by Refiners in itself shows that there was here no intent to evade or avoid taxes.

When consideration is given to the foregoing facts, it is impossible to conclude that the "principal purpose" for the acquisition of Hilo Gas was the evasion or avoidance of income taxes. The taxpayer's purpose must be determined as of the time the acquisition was made and not in the light of later events. When this acquisition was made, taxes were not a factor at all; tax evasion was not any part of the purpose of the acquisition, principal or otherwise. The principal purpose of the acquisition was to obtain the Hilo market for butane. The secondary purpose was to acquire the "Rock Gas" distribution business on the Island of Hawaii. There was no other purpose.

The District Judge draws from the record only *one fact* to support his conclusion—that Hilo Gas lost money in 1948 and 1949 and was in financial difficulty. "In such a situation, it has been held that the principal purpose of the acquisition was the avoidance of Federal income taxes," citing *Elko Realty Co.*, 29 T.C. 1012 (1958), *aff'd* per curiam 260 F.2d 949 (3d Cir. 1958). (R. 88.) The fact that Hilo Gas had lost money in 1948 and 1949 and was in financial difficulty in no way proves that the purpose of the acquisition was tax evasion or avoidance unless it can be shown that the losses had produced an operating loss to be carried forward, that the purchaser knew about this, and that this was the principal reason for the purchase. None of these things can be shown here; indeed, the evidence shows affirmatively that the facts were otherwise. The loss which Refiners has sought to carry forward here is not a loss suffered by Hilo Gas in prior years. Although Hilo Gas may have had a loss in 1948 and 1949 this was of no significance to Refiners which made no attempt to carry forward such losses against its profits and could not have done so in any case under the Consolidated Return Regulations.[7] In 1950 Hilo Gas had an operating profit of $5,138 outside of the loss suffered on sale of assets. (Paragraph XXII, Stipulation of Facts, R. 46-48.)

The loss which Refiners has sought to carry forward here is a loss suffered by Hilo Gas *after* affiliation,

[7]Reg. 129, Section 24.31(a)(3) provides that a loss sustained by a subsidiary *prior* to affiliation cannot be used against the parent's profits after affiliation.

when it sold its utility assets to Honolulu Gas for a consideration which was $122,930 less than the net book value and tax basis of these assets. (Paragraph X, Stipulation of Facts, R. 37-38.) This loss had nothing to do with whether Hilo Gas had suffered losses in 1948 and 1949 and was in financial difficulty. The loss could have been anticipated and planned for taxwise only *if* the officials of Refiners had had access to the books of Hilo Gas before the acquisition of control so that they could have ascertained the book value and tax basis for the utility assets, the amount of depreciation which had been taken, whether obsolescence or abandonment losses on these assets had already been claimed, and the amount of the unrecovered "tax cost" of these assets. With this information, Mr. Englebright might have been able to anticipate a tax saving; without it he could not possibly have known whether or not there was any tax advantage to be gained from acquiring control of the Hilo Gas utility assets. What then are the facts with respect to this information?

The facts are set forth clearly in Paragraphs XVI and XVII of the Stipulation of Facts (R. 41-43):

> "At the time of the acquisition of the stock of Messrs. Lyman and Hutchinson on October 6, 1950, no consideration was given by Refiners to the tax aspects of the transaction. The officials of Refiners did not know what the book value of the Hilo Gas assets was, and the Hilo Gas books were not made available to Refiners until after the decision had been made to purchase the Lyman

and Hutchinson stock. Mr. Lyman has stated that the principal purpose on taking over Hilo Gas was to sell butane not then used by Hilo Gas.

> 'As far as I know no investigation was made into the accumulated losses of Hilo Gas or was the matter discussed at any time between Mr. Englebright and myself during the negotiations. The purpose of the purchase of Hilo Gas Co. was to do away with the old manufactured gas plant and replace it with Butane shipped in from Pacific Refiners.' (Letter of August 27, 1956)
>
> 'Mr. Englebright and I at no time discussed the book value of the assets of Hilo Gas Company.
>
> 'It is also my recollection that your accounting staff did not arrive in Hilo until the day I left the company after the sale. This timing I recollect as pay for my vacation time was left up to your staff. They refused payment. This incident, I believe, helps to place the correct timing of your accountant's access to the books. Mr. Englebright did not look over the books at any time before the purchase.' (Letter of September 17, 1956)

"It was not until November, 1950, that Refiners obtained advice on the tax aspects of the transaction."

The *Elko Realty* case, *supra,* which is the only authority cited by the District Judge to sustain his decision, dealt with quite a different situation. In *Elko* there was no purpose for the acquisition aside from

the tax purpose of acquiring an operating loss. The Tax Court found that "no bona fide business purpose was served by the acquisition." (29 T.C. 1018.) Fox, the principal owner (80%) of Elko Realty Co., was an experienced real estate and mortgage operator. Without making any investigation of the earnings, on January 1, 1951, he acquired all the stock of two FHA financed apartment corporations from the owner, Harry Spiegel, for $15,800. He then transferred the stock to Elko Realty for 9 shares of Elko having a stated value of $900. At the time of the acquisition, the two apartments were operating at a loss and continued to operate at a loss in 1951, 1952 and 1953. In 1954 the FHA foreclosed the mortgages. The losses suffered in 1951, 1952 and 1953 were the same kind of operating losses previously suffered; the pattern of losses remained constant. At the time of the acquisition, Fox knew that the apartment corporations had no working capital and he was aware that most of his purchase money went to pay mortgage obligations of one of the apartment corporations which was in default. Fox was the only witness in the case; the Tax Court observed that his testimony was "unclear and at times inconsistent, although Fox himself conducted the negotiations and the facts of the transaction were peculiarly within his own knowledge." Fox had no reasonable basis for believing that the two apartment corporations were operating successfully. He failed to furnish any convincing evidence that the two acquisitions had as their principal motivation a bona fide business purpose. One of his two "business" reasons

was obviously without substance—to have Elko Realty earn rental and insurance commissions from the two apartment corporations. When Fox had himself bought the stock of the two apartment corporations he could have placed the commissions in the hands of Elko if that was the desired objective, without transferring the stock to Elko. Acquisition of the stock by Elko added nothing to the substance of its ability to secure the commissions. The other "business" reason was that Elko would own two valuable pieces of property when the mortgages were paid off. Since the apartments were unprofitable and the mortgages could not be paid off (and were in fact foreclosed in 1954), this reason also was without substance. In fact there was no reason for an experienced operator like Fox to acquire the apartment corporations except to use their continuing operating losses against the profits of Elko. The Tax Court concluded:

> "Under the circumstances, for petitioner [Elko] to expect us to give serious credence to its assertion that through Fox, a thoroughly experienced businessman, it entered into the transaction in question for a bona fide business purpose requires a degree of naivete which we do not possess." (29 T.C. 1025)

The differences between this case and ours are striking. First, Refiners was a publicly held company (Paragraph II, Stipulation of Facts, R. 25-27) not a privately owned corporation which could be manipulated for tax purposes like the three corporations in *Elko, supra*. Second, the loss in our case is not a con-

tinuation of the pattern of normal operating losses which could have been anticipated by the purchaser without looking at the books, as the Tax Court found the apartment losses to be, but rather a loss on a sale of utility assets which could not have been anticipated without knowledge of their tax basis to be gathered from the books or from inquiries made of the Hilo Gas management, neither of which took place. Third, the Tax Court could not believe that Fox did not know about the financial conditions of the apartment corporations before he bought the stock, in view of his experience, his knowledge of the lack of working capital, his knowledge of the default in the mortgage and the other circumstances. In our case, unless there were in fact tax motives, there was no reason why the officers of Refiners should inquire about the tax basis of the Hilo Gas property or look at the books before the stock was acquired. The officers of Refiners were not interested in acquiring a tax loss (Refiners already had one of its own of almost $100,000). They knew the approximate current value of the Hilo Gas utility assets from the recent report of their own engineer (Paragraph IV, Stipulation of Facts, R. 29-31) so they did not need to inspect the books to determine if the price placed by Mr. Lyman on his stock was reasonable. Fourth, Fox was an unclear and inconsistent witness. There is nothing unclear or inconsistent about the stipulated facts in our case. Fifth, in our case it has been stipulated that "no consideration was given by Refiners to the tax aspects of the transaction" at the time of the acquisition. (Paragraph XVI, Stipula-

tion of Facts, R. 41-42.) No such fact was stipulated or proved in *Elko, supra.* Sixth, there was no rational or bona fide business purpose for Elko's acquisition of the stock of Spiegel's apartments, whereas in our case there are sound and legitimate business reasons for Refiners' acquisition of Hilo Gas. The fact that Refiners had to purchase 650,000 to 1,700,000 gallons of butane a year from Standard, and that it was able to sell 500,000 gallons a year in the Hilo Gas system (Paragraph III, Stipulation of Facts, R. 27-28) is alone sufficient to justify the acquisition as a business matter.

The District Judge appears to accept the argument of the government that the fact that Refiners bought stock for $63,897 and shortly thereafter Refiners sold its assets for $88,754 is in itself a reason for denying the loss carry forward. (R. 87.) The idea seems to be that the fact that Refiners did not pay something for a tax loss it did not know it was getting is fatal to its case. A short answer to this is that there is nothing in the law which outlaws windfalls. Taxpayers frequently have unexpected tax windfalls, just as they sometimes fall into unexpected tax traps. Unless there is some section of the law which prevents Refiners from using the tax loss (such as Section 129 which would prevent it *if* the principal purpose of the acquisition were in fact tax evasion or avoidance), Refiners is entitled to the advantage afforded by the loss recognition, carry forward and consolidated return provisions. The following quotation from the decision of the Supreme Court in *Lewyt Corp. v. Commis-*

sioner, 349 U.S. 237 (1954) where the taxpayer was the beneficiary of an unexpected net operating loss benefit of some $304,000 which cost it nothing, is apposite:

> "But the rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall." (At p. 240.)

Moreover, let us examine the facts more closely. Most of the Hilo Gas stock was acquired on October 6, 1950. Twenty-five days later Hilo Gas sold its assets, after approval of the Public Utilities Commission. If the PUC had refused approval, Refiners would have been left with its full investment of $63,-897.20 unrecovered; there was no contract or legal obligation of Honolulu Gas to purchase the utility assets. The utility assets were in fact sold to Honolulu Gas for $46,000 cash and assumption by Honolulu Gas of liabilities of Hilo Gas in the amount of $25,254. At that point Refiners was still "out of pocket" $17,-896 ($63,897 minus $46,000), assuming all of the $46,000 could be treated as belonging to it. Refiners then purchased non-utility assets of Hilo Gas (bottled

gas, gas appliances, accounts receivable, etc.) from Hilo Gas for $18,500 in cash. (Paragraphs VII, VIII, and X, Stipulation of Facts, R. 35-38.) Thus, Refiners had a fair amount of cash at risk in the Hilo Gas purchase. At that time Refiners had had nothing but operating losses (about $100,000) and every dollar of cash was needed to build the refinery and get the business going. Management's presentation of the reasons for the Hilo Gas investment did not include potential tax benefits. (Paragraph V, Stipulation of Facts, R. 31-34.) As noted above, Refiners was a publicly held company. Its directors, being trustees of the stockholders' money, would hardly have authorized the management to make a cash outlay to purchase Hilo Gas stock if the "principal purpose" of the acquisition was a tax speculation.

As a matter of fact, the payment by Refiners of an amount approximating what the Hilo Gas assets were worth, rather than an amount which included an additional consideration for a potential tax benefit, indicates that neither Refiners nor the Hilo Gas stockholders had any idea of potential tax benefits at the time of acquisition. In commenting on Section 269(c) (the presumption added by the Internal Revenue Code of 1954, which applies only to acquisitions after March 1, 1954) tax writers have pointed out that a purchase for a price substantially equivalent to fair market value indicates that the purchaser had no thought of tax advantages, rather than vice versa:

> "Two problems result from the presumption created by section 269. First, there is ordinarily

no real relation between the basis of the corporate assets and the purchase price paid for the stock. The price is much more likely to be related to net asset value. If we assume a corporation with an asset basis of $100 but a value of $50, a purchase for $50 is less likely to be motivated by tax purposes than a purchase in excess of value which might be motivated by the high depreciation allowance. Thus, if the purchaser has no thought of the tax advantages, he may run into the section 269 presumption simply by having failed to take them into account. Ironically enough, then, it may be easier to overcome the prima facie evidence of disproportionate purchase price the more disproportionate the price may be.'' Cohen, Phillips, Surrey, Tarleau, Warren, ''The Internal Revenue Code of 1954: Carry-Overs and the Accumulated Earnings Tax,'' 10 *Tax L. Rev.* 277, 295-296 (March 1959)

The 1959 report of the Committee on General Income Tax problems of the Section of Taxation of the American Bar Association suggested revising Section 269(c) to provide that if the consideration paid is substantially greater than the net fair market value of the property acquired, then there shall be a presumption of tax evasion or avoidance. In commenting on this, the Committee stated:

''Presumably the correspondence of purchase price to the net value of the assets required would indicate that the acquisition of the assets was not undertaken primarily to acquire a tax benefit. The American Law Institute adopted this approach in its model income tax statute. A.L.I.

Federal Income Tax Statute, Tenative Draft No. 7, Section X661." American Bar Association, *1959 Report of Section of Taxation*, at p. 79.

If good business reasons for the acquisition exist the presence or absence of a tax saving motive is immaterial. The decisions under Section 129 make it clear that the section does not apply *even if there is a tax saving motive* so long as the principal purpose is a legitimate business purpose. If the purpose of a transaction is legitimate, the accompanying tax avoidance purpose is legally neutral. The Commissioner has been consistently unsuccessful in trying to invoke Section 129 when a legitimate business purpose was present, *even though a tax saving purpose was concededly present in each of these cases.* Following is a list of these cases showing the business reasons which were found to be present. Note that in a large number of the Tax Court cases the Commissioner has *acquiesced* in the decision. *Alprosa Watch Corp.,* 11 T.C. 240 (1948) (the acquisition of an existing corporation was necessary to market Pierce watches); *Alcorn Wholesale Co.,* 16 T.C. 75 (1951)(A) (reasons for splitting into five corporations were to increase combined borrowing capacity, to limit liability for tort judgments, to permit handling of competitive lines of merchandise, to eliminate prejudice against absentee ownership); *Berland's, Inc.,* 16 T.C. 182 (1951)(A) (branch stores incorporated separately so that parent would not be liable for lease rentals); *Chelsea Products, Inc.,* 16 T.C. 840 (1951) (*Aff'd* in part 197 F.2d 620) (sales companies organized and operated to reduce tort lia-

bility, to establish local operators, to save freight charges); *Commodores Point Terminal Corp.*, 11 T.C. 411 (1948)(A) (stock control of Piggly Wiggly Co. acquired to secure dividend income which would provide funds for repairs of facilities and interest payments on mortgage bonds); *W A G E, Inc.*, 19 T.C. 249 (1952)(A) (merger of radio station into auto dealer to make available liquid assets for broadcasting business); *Dilworth Co. v. Henslee*, 98 F.Supp. 957 (M.D. Tenn. 1951) (Tennessee corporation formed Mississippi corporation to conduct Mississippi operations—State purchasing authorities and other Mississippi customers preferred to deal with local corporation; Mississippi State taxes could be more easily determined with separate corporation); *John P. Wagner*, 17 CCH Tax Ct. Mem. 569, 614 (1958) (because cost of insurance was prohibitive four corporations were organized to minimize the risk of liability); *Virginia Metal Products, Inc.*, 33 T.C. ...., No. 88 (1960) (acquisition of stock of Arlite was for a bona fide business purpose of getting into the aluminum window and partition business and the Commissioner erred in disallowing a net operating loss carry over in the consolidated return). With respect to tax purposes the Tax Court has said:

> "As pointed out in Treasury regulations and in the reports of the committees of Congress, a tax avoidance purpose incidental to such a transaction does not necessarily bring it within the condemnation of section 129. The tax avoidance purpose must exceed in importance any other purpose to constitute the 'principal purpose.' The

> fact that Lovett may have made a tax saving is of no moment." *Commodores Point Terminal Corp.,* 11 T.C. at p. 418.
>
> "The consideration of the tax aspects of the plan was no more than should be expected of any business bent on survival under the tax rates then current. Such consideration is only the part of ordinary business prudence. It does not follow automatically from the fact that tax consequences were considered, that tax avoidance was the principal purpose of Berlands' organization of the petitioning corporations." *Berland's, Inc.,* 16 T.C. at p. 188.

As a matter of fact, the Commissioner had so little success in establishing a principal tax purpose where a business purpose was also present that Congress added Section 269(c) to the 1954 Code to give him a helping hand. The Senate Finance Committee commented: "The effectiveness of this provision [Section 129] has been impaired by the difficulty of establishing whether or not tax avoidance was the principal purpose of the acquisition." S.Rep. No. 1622, 83d Cong., 2d Sess., at p. 39. See also 7 Mertens, *Law of Federal Income Taxation,* Section 38.69. Section 269(c) is not applicable here because by its terms it applies only with respect to acquisitions after March 1, 1954. As we are dealing with the old law, it is evident not only that the presumption introduced by Section 269 (c) cannot be used to aid the Government, but also that all of the difficulties which the Commissioner encountered in trying to apply Section 129 are present in our case.

In its brief below the Government relied on *American Pipe & Steel Corp.,* 25 T.C. 351 (1955) *aff'd* 243 F.2d 125 (9th Cir. 1957), *cert. denied* 355 U.S. 906 (1957). Although the District Judge did not cite the case, it is a leading one in the field and should be considered here. We believe that the predominant tax purpose of the acquisition in *American Pipe* and the almost complete absence of business purpose distinguish this case from ours.

American Pipe was engaged in the steel fabricating business. Stock control was in Lane (President) and Krieger (Secretary and Treasurer). With the onset of World War II, American Pipe was on the threshold of obtaining many profitable government contracts and its prospective profits "loomed large." Palos Verdes Estates, Inc., a real estate company, had been in poor financial condition since 1936 and was not actively engaged in business. Its principal assets were 695 unsellable residential lots, with a tax basis in excess of $430,000 and a market value of about $25,000. Lane had been long familiar with the real estate in the Palos Verdes area, having maintained a real estate broker's office four miles to the north. In the spring of 1942 Archer, a real estate broker, informed Lane of the Palos Verdes situation. Lane made an "exhaustive study" of the lots owned by Palos Verdes. In July of 1942 Archer joined American Pipe, ostensibly as an "expediter" and "accountant." In fact he was used as a middleman to acquire stock of Palos Verdes for American Pipe. Promptly after acquiring control, American Pipe caused Palos Verdes to sell

its lots at a loss, mostly to a friend of Lane who was financed by American Pipe. The taxpayer argued that there was a business purpose for the acquisition, citing a letter from Lane to his stockholders saying the acquisition would enable American Pipe to improve its position in the sale of pipe and casing in real estate developments and would provide an organization for marketing postwar metal houses. When it is remembered that Palos Verdes was practically a defunct organization with only three employees (two, part time), with no business or assets except residential lots which it had been unable to sell, it is not surprising that the court refused to give much weight to these "reasons." This Court thought that *any* corporation formed to do business in the real estate field would have satisfied the *alleged* needs of American Pipe, and that the reasons advanced by the taxpayer did not overshadow the conclusion that the acquisition was for a huge potential tax benefit (tax losses of $400,393.91 acquired for a total stock cost of $11,248.96). It is perfectly evident from the facts that Lane knew all about the condition of Palos Verdes and the potential tax benefits and that Palos Verdes had no assets or business of real interest to American Pipe—its only asset was its potential tax loss. The situation in our case is quite different—the officers of Refiners knew nothing about the tax basis of the Hilo Gas assets until after the acquisition; they did not consider tax aspects until after the acquisition; Refiners had no prospective profits "looming large"; Refiners needed to acquire Hilo Gas to secure

a market for its butane; Hilo Gas was in the same general business as Refiners and the continuation of the gas business on the Island of Hawaii was of vital interest to Refiners. Refiners in the summer of 1950 was a brand-new business, with operating losses of its own and no possible need of another's operating loss.

The decision in *American Pipe,* 25 T.C. 351 (1955) makes it clear that Section 129 requires a determination of the subjective *intent* of the taxpayer and that intent must be to avoid or evade taxes. "Of course, the statute was not intended to upset bona fide transactions or acquisitions where the proscribed *intent* is not present." 25 T.C. at p. 365. The taxpayer must have *"the principal purpose or intent* underlying such acquisition of evading or avoiding" taxes. 25 T.C. at p. 366. "Although *intent* is a state of mind, it is none the less a fact to be found." 25 T.C. at p. 366. (Emphasis added.) In our case, the facts are that there was *no intent* whatever to evade or avoid taxes when Refiners purchased control of Hilo Gas. Rather, this was a bona fide business transaction which the statute was not intended to upset.

There is another significant difference between this case and *American Pipe:* Here we have a stipulation that at the time of the acquisition of the controlling stock "no consideration was given by Refiners to the tax aspects of the transaction". (Paragraph XVI, Stipulation of Facts, R. 41-42.) There was no such stipulation in *American Pipe* and the court found that major consideration was given to the tax aspects. If

no consideration was given to the tax aspects of the transaction, the tax avoidance *intent* required by *American Pipe* cannot possibly be found.

Because taxes were not considered, our case is also stronger for the taxpayer than the Section 129 cases referred to above, which found for the taxpayer despite the fact that taxes were considered. Our case is further enforced by the statement of the *seller* (Mr. Lyman) that no investigation was made of the losses of Hilo Gas or the book value of the assets and that the purpose of the purchase was to do away with the old manufactured gas plant and replace it with butane shipped by Refiners. There is no fact in the record which is inconsistent with the actual business purpose of the acquisition of control and no fact which is consistent with the alleged tax evasion purpose.

The District Judge found that the taxpayer has the burden of proof here to show that Section 129 is not applicable, citing a case to show that the burden of proof is on the taxpayer to show that *the Commissioner's* determination is invalid. (R. 89.) The Tax Court has also held that where *the Commissioner* has determined that the principal purpose of the acquisition was to gain a tax benefit, the burden of proof is on the taxpayer to show otherwise. *American Pipe, supra,* 25 T.C. 366; also *Elko Realty, supra.* That may be, but the Commissioner in this case did *not* determine that the principal purpose of the acquisition was tax evasion or avoidance. Section 129 was not cited or referred to as a reason for disallowing the loss carry forward. (Paragraph XXII, Stipulation of Facts, R.

46-48.) The defense of the applicability of Section 129 was first raised by the Department of Justice, not the Commissioner, in its brief in the court below. Under the circumstances, does not the burden of proof with respect to this defense rest on the Government rather than the taxpayer?

Whoever has the burden of proof, we submit that the stipulated facts here establish that the principal, indeed the only purpose, of the acquisition of Hilo Gas by Refiners was a business purpose, and that there is no evidence of any kind to support the District Judge's conclusion that the principal purpose was tax evasion or avoidance.

This being an appeal from a District Court, the provisions of Rule 52(a), Federal Rules of Civil Procedure, are applicable: "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial Court to judge of the creditability of the witness." In a leading case, the Supreme Court has held that a finding is "clearly erroneous" when "although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *United States v. Gypsum Co.,* 333 U.S. 364, 395 (1948). In this case, we submit, there is no evidence at all to support the District Judge's findings of fact on this issue.

Where findings of fact are based on documentary evidence, such as depositions or stipulations of fact, this court and many others have held that the review-

ing court is in just as good a position as the trial court to judge creditability and the findings of fact are not binding on the appellate court and will be given slim weight on appeal. *Equitable Life Assur. Soc. v. Irelan,* 123 F.2d 462, 464 (9th Cir. 1941); *Stevenot v. Norberg,* 210 F.2d 615, 619 (9th Cir. 1954); *United States v. Fotopulos,* 180 F.2d 631, 638 (9th Cir. 1950); *Orvis v. Higgins,* 180 F.2d 537, 539 (2d Cir. 1950) (where the trial judge "decides a fact issue on written evidence alone, we are as able as he to determine creditability, and so we may disregard his finding"); 5 *Moore, Federal Practice* ¶52.04, at 2637 (2d ed. 1953). In *Elko Realty, supra,* Fox was a witness (the only one) and evidently his creditability did not impress the Tax Court; the Court of Appeals affirmed *per curiam* evidently being reluctant to disturb a finding based in large part on oral testimony of an "unclear" and "inconsistent" witness. The evidence in the present case is entirely a written stipulation of facts; there is no question of observing the creditability of witnesses; this court is in just as good a position as the trial court to make a finding of fact on the purpose of the acquisition of Hilo Gas by Refiners.

C. IF SECTION 129 IS NOT APPLICABLE, REFINERS AND HILO GAS CANNOT BE DENIED THE PRIVILEGE OF FILING CONSOLIDATED RETURNS UNDER SECTION 141.

Aside from Section 129, the District Court gives one other basis for its decision as follows: "Section 141 of the Code of 1939, which extends the privilege

of making consolidated returns to affiliated groups, may not be utilized to distort income by acquiring a 'loss corporation' for a nominal consideration, and then using such corporation's losses to avoid taxes." (R. 87.)

No authority is cited for this sweeping pronouncement. Certainly, there is nothing in the Internal Revenue Code (unless it be Section 129) which authorizes the Commissioner to deny to taxpayers the privilege of filing consolidated returns under Section 141. The statute itself prescribes no test or prerequisite to its applicability other than 95% stock ownership:

> "The statute invoked by Fox, section 141, Internal Revenue Code of 1939, authorizes the filing of consolidated returns by an affiliated group of corporations, where stock possessing at least 95 per cent of the voting power and of the non-voting stock of each is owned directly by one or more of the others. * * * The statute prescribes no test of affiliation other than stock ownership. Even if Fox's primary purpose was to reduce his own tax liabilities by offsetting the probable losses from the Post against the expected income from the dividends and gas leases through the means of a consolidated return, that is a legitimate purpose and the action is authorized by the statute." *John Fox,* 17 CCH Tax Ct. Mem. 1006, 1019 (1958).

The sole test of what is a member of an affiliated group is statutory and the only requirement is the requisite stock ownership. Section 141(d) and (e); *Burnet v. Aluminum Goods Co.,* 287 U.S. 544, 547-8

(1932); *Autosales Corp. v. Commissioner,* 43 F.2d 931, 933 (2d Cir. 1930); *Hancock Construction Co., et al.,* 11 B.T.A. 800, 804 (Acq. 1928).

It is quite obvious that Congress intended to give corporations which complied with the provisions of the law the privilege of filing consolidated returns and offsetting the losses of one member of the group against the profits of another member, even though this resulted in tax savings and to that extent "distorted income." It has been perfectly clear to Congress from the beginning that a large advantage of the consolidated return provisions was to permit a parent to offset its own gains against the losses of a subsidiary. Indeed, this was the principal reason the consolidated return privilege was eliminated in 1934 and not restored until 1942. 8 Mertens, *Law of Federal Income Taxation,* Section 46.02. In the report accompanying the 1934 Act the Ways and Means Committee of the House stated:

> "The subject of consolidated returns has long been in controversy. * * * It cannot be denied that the privilege of filing consolidated returns is of substantial benefit to the large groups of corporations in existence in this country. This is especially true in depression years, for the effect of the consolidated return is to allow the loss of one corporation to reduce the net income and tax of another, and during a depression more losses occur." H.R. Rep. No. 704, 73d Cong., 2d Sess., Seidman, *Legislative History of Federal Income Tax Laws 1938-1861,* 377 (1938).
>
> "The principal tax advantage reflected in a consolidated return computation, one that has been

> affirmatively recognized in all Treasury regulations, is the rule pertaining to the computation of consolidated net income, the rule which permits the losses or expenses of one affiliate to be offset against the profits of another." V. J. Heffernan, "Points to Be Considered in the Filing of Consolidated Returns," 5 N.Y.U. *Institute on Federal Taxation* 283, 286.

Section 141 confers a *privilege* of filing consolidated returns. An extra 2% tax is imposed for exercising that privilege. (Section 141(c).) The Secretary of the Treasury is required to prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group may be determined in such manner as clearly to reflect income. (Section 141(b).) Under the Consolidated Return Regulations losses of a subsidiary realized *prior* to affiliation cannot be carried forward and used against the profits of a parent after affiliation. On the other hand, losses of a subsidiary realized *after* affiliation may be carried forward and used against the profits of a parent in another year of the consolidated return period. See Reg. 129, Section 24.31(a)(1), (2), (3), (5) and (6) and Section 24.31(b)(3). The only requirement is that the loss of the subsidiary must be realized *after* affiliation—not before. If there is any "distortion" of income when a taxpayer complies with these regulations and utilizes a post-affiliation loss of a subsidiary against income of the parent during the consolidated return period, it is a "distortion" knowingly provided for by Congress and by the Treasury's own regulations.

The Code does not say that a corporation is entitled to a deduction for "economic" losses sustained during the taxable year but that it may not deduct losses which are not "economic" losses. Section 23(f) (losses by corporations) refers merely to "losses sustained during the taxable year." In the case of sales of property a "loss", for tax purposes, is the excess of the basis (cost) of the property over the selling price. Sections 111(a) and 113(b), IRC 1939. In consolidated returns, the profits or losses for each affiliate are figured out for the taxable period and then combined to arrive at the consolidated net income or loss for the period. Reg. 129, Section 24.31(a). There is not a word in the Code or in the lengthy and complex Consolidated Return Regulations which requires that only "economic" losses may be considered in these computations. Furthermore, there is nothing in the Code or Regulations which says that a parent is not entitled to consolidate a subsidiary unless it paid more than a "nominal consideration" for the subsidiary's stock. The parent must own 95% of the stock—how it got it or what it paid for it is immaterial. (Section 141(d).)

Any such vague requirement as "economic loss" would be impossible of statutory or regulatory definition, impossible to apply, impossible to administer. The nearest thing to such a requirement is the "disproportionate purchase price" provision of Section 269(c) which takes a dozen lines of statutory language to spell out and is applicable only to acquisitions made after March 1, 1954. Section 269(c) has been criti-

cized as "filled with obscurity" and "likely to raise more questions than it will help solve." (7 Mertens, *supra,* Section 38.69. How much more unworkable would be an *unwritten* rule permitting the Commissioner to deny affiliation whenever there is "no economic loss" to the parent. If there were such a rule, it is safe to say no parent corporation would elect to file consolidated returns as the principal benefit resulting therefrom could be denied almost at the whim of the Commissioner.

It may be that Congress should have written some additional restriction into Section 141 to prevent a parent utilizing a post affiliation loss of a subsidiary in a consolidated return period in a case where the parent's cost of acquisition of the subsidiary is less than the amount of the loss. However, Congress has not done so and neither the Treasury nor the Courts may add to a tax statute something which is not there. See *Commissioner v. Acker,* ...... U.S. ...... 4 L ed 2d 127, 131 (1959); *United States v. Calamaro,* 354 U.S. 351, 359 (1957); *Koshland v. Helvering,* 298 U.S. 441, 447 (1936); *Reinecke v. Gardner,* 277 U.S. 239, 244 (1928); *Manhattan Co. v. Commissioner,* 297 U.S. 129, 134 (1936); *Smietanka v. First Trust & Savgs. Bank,* 275 U.S. 602, 606 (1922); *Commissioner of Internal Revenue v. Reece,* 233 F.2d 30, 33 (1st Cir. 1956).

The situation is even stronger here than in the usual case where the Code is silent and the Treasury attempts to fill the gap with a regulation. As noted above, Section 141(b) gives the Secretary express

power to prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations may be determined in such manner as to clearly reflect income. The Consolidated Return Regulations, promulgated pursuant to this provision, not only do not prevent the taxpayer from doing what was done here, they *require* the returns to be prepared and the income to be determined in this manner. Reg. 129, Section 24.31 provides that in the case of an affiliated group of corporations which makes a consolidated return, the tax liability *shall* be determined subject to the rules of computation set forth in paragraphs (a) and (b) of the section. Refiners and Hilo Gas admittedly complied with these regulations. That being the case, how can it be said that the resulting computation "distorts income," a conclusion apparently reached by the District Judge?

In the court below, the Government took the position in its brief that assuming Section 129 is not applicable, affiliation under Section 141 could be denied because the acquisition did not serve a business purpose, citing *J. D. & A. B. Spreckels Co.,* 41 B.T.A. 370 (1940). This is really no more than the Section 129 argument all over again—if there is no business purpose for the acquisition as distinct from a tax saving purpose, the principal purpose of the acquisition is tax avoidance or evasion and the benefits of consolidation can be denied under Section 129 or the *Spreckels* rule. On the other hand, if there is a legitimate business purpose for the acquisition, neither Section 129 nor the *Spreckels* rule is applicable. It

all turns on the factual question—was there a legitimate business purpose?

The *Spreckels* case, which arose before Section 129 was added to the Code, is another instance of corporate transactions undertaken without any business purpose at all, but solely for tax reasons. The Spreckels Company and the Spreckels Securities Company were owned by the same members of the Spreckels family in the same proportions. The Securities Company owned all the stock of the Savage Tire Company. Prior to 1927 the Tire Company sustained operating losses and in that year its manufacturing operations were discontinued, and until 1930 or 1931 it rented its plant to others. In 1931 the Securities Company considered the capital stock of the Tire Company to be worthless and wrote down its book investment in the stock to $1. In its separate Federal income tax return for 1931, the Securities Company claimed a loss in the amount of $9,175,149 on its investment in the stock of the Tire Company. On November 22, 1932, the Tire Company contracted to sell its plant to the Aztec Brewing Company for $50,000. On November 25th a down payment of $5,000 was made and an agreement was signed to sell and purchase the plant and to pay the balance of the purchase price over a period of time. It was intended that the Brewing Company would take possession of the Tire Company's plant at the end of 1932. On February 20, 1933, the Tire Company executed a deed conveying the plant to the Brewing Company. The deed was deposited in escrow to be delivered when the purchase

price was paid in full. Also on February 20, 1933, the Spreckels Company acquired all of the stock of the Tire Company from the Securities Company for $1. On April 5, 1933, the Brewing Company paid the remainder of the purchase price and received a deed to the plant. On the sale of its plant the Tire Company sustained a loss of $192,849. For the year 1933 the Spreckels Company filed a consolidated return, including the income of the Tire Company for the ten-month period beginning March 1, 1933. A deduction of $191,268 was taken in the consolidated return as the net loss sustained by the Tire Company during the last ten months of the taxable year on the sale of the plant. The Commissioner disallowed the deduction of the net loss of the Tire Company, primarily on the ground that the Tire Company was not a member of the affiliated group. The Board of Tax Appeals sustained the Commissioner.

In short, the Spreckels Company acquired from the Securities Company (same stockholders) for $1 all the stock of the insolvent Tire Company which was not engaged in any business and which had made a binding agreement to sell its assets at a loss of some $191,000. The Spreckels Company had a very substantial net income. There was no possible business reason for the transaction—no business reason was even urged by the taxpayer. The sole purpose of the transaction was to obtain the loss of the Tire Company for tax purposes. The Board of Tax Appeals found that there was no business purpose for the Spreckels Company to acquire the stock of the Tire

Company in February, 1933 and that therefore the affiliation could be denied by the Commissioner.

In *Spreckels* the Board of Tax Appeals referred to and distinguished *Bishop Trust Company, Limited,* 36 B.T.A. 1173 (1937)(A). Bishop Trust Company acquired all the stock of Waterhouse Trust Company at the time when the Waterhouse Company was in failing condition. The stock was acquired, *without cost* to Bishop Trust Company, for the purpose of preventing the failure of the Waterhouse Company, preventing loss on the part of clients of the Waterhouse Company, and acquiring new clients for Bishop Trust Company. The stock was acquired on February 14, 1931. On May 29, 1931 the manager of Bishop Trust Company informed the directors that the operation of the Waterhouse business was causing a monthly loss "as it is in the nature of a receivership." The Waterhouse Company was continued as a separate organization until it was merged into the Bishop Trust Company on December 30, 1933. Bishop Trust Company filed consolidated returns for 1931, 1932 and 1933 in which it took advantage of the Waterhouse losses against its own income. The Board held that the Commissioner's determination denying the affiliation and the privilege of filing consolidated returns was in error, stating:

> "There was no acquisition of a subsidiary for the sake of its prior net losses within the condemnation of the *Woolford Realty* decision. The clear implication of that decision is that the losses of one affiliate are available to offset tax-

> able net income of another if sustained during the period of affiliation—which is the situation here. *Gregory v. Helvering,* 293 U.S. 465, is wholly inapplicable unless it is to be read as disapproving any construction of a statutory term like reorganization or affiliation which recognizes a lower tax. That case revealed a sham, and the Court disregarded the mask and dealt with realities; but, as in *Helvering v. Minnesota Tea Co.,* 296 U.S. 378, it can here be said, 'The present record discloses no such situation; nothing suggests other than a *bona fide* business move.' " (at p. 1180.)

Our case is like the *Bishop Trust Company* case and unlike the *Spreckels* case in that there was a *bona fide* business purpose for the acquisition of Hilo Gas and that the acquisition was made without thought of tax benefit. In the *Bishop Trust Company* case it was certain that a tax benefit would arise because the Waterhouse Trust Company was hopelessly insolvent and liquidation of its affairs could not be expected to prove profitable. Since the Bishop Trust Company was making a profit, the tax advantage of filing consolidated returns and using the loss of the Waterhouse Company for the three years, 1931, 1932 and 1933, was obvious. Nevertheless, because there was a bona fide business motive for the acquisition, affiliation was not denied. In the *Spreckels* case, on the other hand, there was no business purpose whatever in the Spreckels Company acquiring the stock of the Tire Company for $1. The sole purpose was a tax reducing purpose. The *Spreckels* decision dis-

tinguished *Bishop Trust* in the following language which could be applied almost verbatim to the present case:

> "In that case [*Bishop Trust*] the stock of the subsidiary was acquired as a '*bona fide* business move.' One of the purposes for the acquisition of the stock of the subsidiary was to enable the parent corporation to take over the business of the subsidiary." (at p. 377.)

David's Specialty Shops v. Johnson, 131 F. Supp. 458 (S.D.N.Y. 1955) is another case holding that where there was no business purpose for the affiliation other than tax reduction, the affiliation will be denied. The court held that groundless fear of liability on a bond was not a business purpose and that, anyway, affiliation was not necessary because plaintiff could have advanced the money to pay the debt, as in the past, without affiliating. The decision has been severely criticized by a leading tax textbook for substituting the court's judgment on "groundless fear" for that of the taxpayer. "It does not appear to be proper, however, when the sincerity of the reason advanced is admitted, for a court to substitute its judgment for that of the taxpayer as to the reasonableness of the admitted purpose. This is especially unfair since the court, if it substitutes its judgment, has the benefit of hindsight as well as an incomplete grasp of all the considerations which motivated the taxpayer in its decision." 8 Mertens, *supra,* Section 46.09. In any event, the decision is helpful to our case rather than otherwise because it

holds that where there is a business reason for the acquisition, the tax benefit from filing consolidated returns cannot be denied, even though the stock of the subsidiary had been donated to the parent and so cost it nothing: "* * * If plaintiff's affiliation with Holding Corp. served a purpose other than or in addition to that of tax reduction, plaintiff may take advantage of the tax benefit that accrued to it by reason of the affiliation. * * *" (at p. 460.)

In the court below the Government also relied on *Gregory v. Helvering,* 293 U.S. 465 (1935). This case held that a letter perfect "reorganization" could be disregarded for tax purposes because it had no business or corporate purpose but was a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character. The taxpayer created a temporary corporation (which lasted six days) to effect a tax saving in the distribution of corporate shares to herself by coming under the reorganization provisions. There was a preconceived plan not to reorganize a business but to transfer corporate stock to the taxpayer—the corporation was nothing more than a contrivance to this end; it was brought into existence for no other purpose; it performed and was intended to perform no other function; it was then immediately put to death. It was an elaborate and devious form of conveyance masquerading as a corporate reorganization and nothing else.

In the present situation there is no artifice or device created to accomplish a tax purpose. The pur-

chase of the stock of Hilo Gas and the sale of the utility assets to Honolulu Gas were not fictitious or sham transactions, or temporary devices for securing tax benefits. Hilo Gas was an established business of long standing. The business was continued by Refiners and Honolulu Gas after the acquisition of control by Refiners—indeed securing a continuance of the gas business on the Island of Hawaii was a purpose of the acquisition. The transactions were in fact no different from what they purported to be. The business reasons for Refiners' purchase of the Hilo Gas stock have been given. The business and regulatory reasons why Refiners rather than Honolulu Gas purchased the stock have been given. The reason for selling the utility assets to Honolulu Gas is obvious—Refiners was not a utility subject to the regulation of the Public Utilities Commission and did not want to become one. (Paragraph III, Stipulation of Facts, R. 27-28.) It is difficult to see how the holding of *Gregory v. Helvering,* 293 U.S. 465, has any pertinence here. As stated in the *Bishop Trust* case, *supra:*

> "*Gregory v. Helvering* is wholly inapplicable unless it is to be read as disapproving any construction of a statutory term like reorganization or affiliation which recognizes a lower tax." (at p. 1180.)

If there is a bona fide business purpose and the transaction is real and not a sham, it will stand up whether or not there was a tax savings—"distortion of income" in the Government's view. Perhaps the leading interpreter of the meaning of *Gregory v.*

Helvering, supra, is Judge Learned Hand, who wrote the opinion in the Circuit Court which was affirmed on appeal. In a later case, *Chisholm v. Commissioner,* 79 F.2d 14 (2d Cir. 1935) *cert. denied* 296 U.S. 641, Judge Hand made a celebrated pronouncement on *Gregory v. Helvering, supra.* Here two brothers had for six or eight months discussed forming a partnership to manage their properties (one wanted to get out of business); on September 26 they gave a thirty-day option to K to purchase their shares in H Co. at a profit to them; K agreed on October 11 to take up the option, which could only be done by paying cash before its expiration; their attorney then told the brothers they could postpone or escape taxes by forming a partnership and transferring the H shares to it; this was done on October 22; on October 24 K purchased the H shares from the partnership. The Commissioner urged that the brothers rather than the partnership should be taxed on the gain, relying on the fact that the firm was organized to escape taxation and citing *Gregory v. Helvering, supra.* The Court of Appeals held that since the firm was a bona fide organization engaged in the business of managing the brothers' properties, *Gregory v. Helvering, supra,* was not applicable despite the tax savings—"* * * a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it * * * . In *Gregory v. Helvering, supra,* the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood

that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world." (at p. 15.) See also the perceptive discussion of the *Gregory* case in *Granite Trust Co. v. United States,* 238 F.2d 670, 677 (1st Cir. 1956); *Sun Properties v. United States,* 220 F.2d 171 (5th Cir. 1955); *The Diamond A. Cattle Co. v. Commissioner,* 233 F.2d 739 (10th Cir. 1956).

SECOND ISSUE: HAWAII INCOME TAXES ON CAPITAL GAINS REALIZED IN 1955 ARE DEDUCTIBLE.

FACTS

The stockholders of Refiners on November 25, 1955 adopted a plan of complete liquidation which provided for the sale of the refinery facilities to Standard, the sale of the remaining operating assets (Isle-Gas business and related assets) to Honolulu Gas and the liquidation and dissolution of the corporation. Pursuant to this plan, the refinery facilities were sold to Standard on December 6, 1955 and the Isle-Gas business and related assets were sold to Honolulu Gas on December 31, 1955. Thereafter, and within a period of twelve months from the date of adoption of the plan of liquidation, the affairs of the corporation were wound up, all of the assets of the corporation were distributed in complete liquidation, less assets retained to meet

claims, and the corporation was dissolved by order of the Treasurer of the Territory of Hawaii on November 19, 1956. No gain or loss to Refiners was recognized on the sale of its assets to Standard and Honolulu Gas as aforesaid, pursuant to the provisions of Section 337, Internal Revenue Code of 1954. (Paragraph XXVII, Stipulation of Facts, R. 49-50.)

The Territory of Hawaii net income tax law which was applicable in 1955 did not have any non-recognition provision similar to Section 337 of the Federal Code.[8] Consequently, a portion of Refiners' 1955 Hawaii net income tax was allocable to the gain from the sale of the refinery facilities to Standard and the gain from the sale of the Isle-Gas business and related assets to Honolulu Gas. The Commissioner allocated $61,061.59 of the 1955 Hawaii net income tax to these gains and disallowed the deduction of this amount for Federal income tax purposes. The reason given for the disallowance is that Section 265 of the Internal Revenue Code of 1954 "prohibits the deduction of expenses allocable to income exempt from federal income tax." (Paragraph XXIX, Stipulation of Facts, R. 50-51.)

[8]The Hawaii Income Tax Law of 1957, which makes the Federal Internal Revenue Code generally applicable, now incorporates such a non-recognition provision.

ARGUMENT.

A. SECTION 265 ("EXPENSES AND INTEREST RELATING TO TAX EXEMPT INCOME") IS NOT APPLICABLE BECAUSE NON-RECOGNIZED GAINS UNDER SECTION 337 ARE NOT INCOME "WHOLLY EXEMPT" FROM THE INCOME TAX.

Section 337(a)[9] is a new section of the Code added in 1954 to eliminate double taxation in certain corporate liquidations, as follows:

> "SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.
>
> "(a) *General Rule.*—If—
>
> "(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and
>
> "(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,
>
> then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period."

Section 164(a) provides that, except as otherwise provided in this section, there shall be allowed as a deduction taxes paid or accrued within the taxable year. There is no exception for State or Territorial income taxes. Consequently, Refiners is admittedly entitled to a deduction for Hawaii taxes paid or accrued for the year 1955, unless some other section of the law prohibits it. The Commissioner contends that

---

[9]References in this section of the brief, unless otherwise noted, are to sections of the Internal Revenue Code of 1954.

Section 265 prevents the deduction of Hawaii income taxes allocable to the gain from the sale of Refiners' assets pursuant to its plan of liquidation.

Section 265 is as follows:

> "SEC. 265. EXPENSES AND INTEREST RELATING TO TAX-EXEMPT INCOME.
>
> "(1) *Expenses.*—Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) *wholly exempt from the taxes imposed by this subtitle*, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.
>
> "(2) *Interest.*—Interest on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest on which is wholly exempt from the taxes imposed by this subtitle." (Emphasis added.)

Capital gains not recognized because of the provisions of Section 337 of the Internal Revenue Code do not constitute income "wholly exempt" from taxes within the meaning of Section 265(1). Consequently, Section 265(1) is not applicable in this situation and the total Hawaii income tax for 1955 should have been allowed as a deduction by the Commissioner.

The Internal Revenue Code has consistently made a distinction between *exempt income* and *non-recognized gains.* In the 1939 Code many of the exempt items were contained in Section 22(b) which commenced: "(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:". In contrast the non-recognition provisions, many of which were collected in Section 112(b), merely provided for non-recognition of gain or loss, and did not state that the gain should not be included in gross income or should be exempt from taxation. Section 112 was entitled *"Recognition of Gain or Loss."* Section 112(a) provided:

> "(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section."

Section 112(b) (1) is typical:

> "(b) *Exchanges Solely in Kind.* —
>
> "(1) *Property Held for Productive Use or Investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment * * * is exchanged * * *."

The distinction is carried over to the 1954 Code. Part III of Subchapter B of Subtitle A is entitled: "ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME," and lists numerous items with the introductory phrase, "gross income does not include."

See Sections 101 to 120, inclusive. Section 121, *"Cross References to Others Acts"*, states:

"(a) For *exemption* of—

"(1) Adjustments of indebtedness under wage earners' plans, see section 679 of the Bankruptcy Act * * *." etc. (Emphasis added.)

It is clear that all of the items in Part III, Sections 101-121, inclusive, are intended to be treated as *exemptions*. The non-recognition provisions, on the other hand, state merely that "no gain or loss shall be recognized," with no reference to exemption or to exclusion from gross income. See for example, Sections 332, 337, 351, 354, 361, 1031, 1032 and 1033.[10]

There is a reason for the distinction. In the case of exempt income, the income is permanently exempt; it will never be taxed. In the non-recognition situation the gain in question is simply not taxed in the particular transaction that qualifies for non-recognition treatment; it may be taxed if the transaction fails to meet the non-recognition requirements or it may be taxed

---

[10]The distinction between exemption and non-recognition is pointed out in a law review article which supports our position on this issue. Charles MacLean, Jr., "Taxation of Sales of Corporate Assets in the Course of Liquidation," 56 *Colum. L. Rev.* 641 (May, 1956) states:

"In computing a liquidating corporation's taxable income, a Treasury agent has reportedly taken the position that Sec. 265 operates to deny deductions for state income taxes paid on gains that are not recognized under Sec. 337. This interpretation of Sec. 265 seems wrong since the statute disallows only deductions that are allocable to income 'wholly exempt' from federal income taxes. In cases involving specific classes of income, the Internal Revenue Code appears to distinguish between exemption and non-recognition." (at p. 672, footnote 92.)

at another time. In short, it is not "wholly exempt" from the income tax.

In adopting Section 337 Congress was well aware of these two long standing contrasting statutory provisions, one providing that gain is "not recognized" and the other providing that gain or income is "not included in gross income" or is "exempt" from tax. In using the "not recognized" phrase in expressing the purpose of Section 337 Congress has answered the present question in favor of Refiners because Section 265, as it has for many years, applies to income "wholly exempt" from tax and not to gains "not recognized." But, beyond this, a consideration of the purpose and requirements of Section 337 will demonstrate that the phraseology chosen by Congress in that section is accurate, because the philosophy of Section 337 is not only similar to that of the other "non-recognition" provisions but is also completely contrary to that of the "exemption" sections.

Section 337 was adopted to eliminate the *double* taxation which occurs when a corporation sells its assets at a profit and then liquidates, there then being one tax on the corporation and another on the stockholders who surrender their stock for assets in a taxable liquidation. See *Commissioner v. Court Holding Co.,* 324 U.S. 331 (1945). Section 337 does not apply unless at least *one* tax (that on the stockholders) is incurred within a year of the adoption of the plan of liquidation. This is clear from the law itself since Section 337(c)(1)(B) and (2) deny the use of the section where the liquidation is tax free to the stock-

holders either under Section 332 or 333. This is also made abundantly clear by the legislative history of Section 337. Congress was willing to provide that the gain on the sale of assets by the corporation would not be recognized to the corporation provided the corporation promptly sold its assets and distributed the proceeds to the stockholders who would then have to pay a tax on the gain and the Treasury could realize its revenues promptly.[11]

The following extracts from the House and Senate Committee Reports disclose the purpose of Section 337 and the explicit understanding of Congress that the gain not recognized to the Corporation is promptly taxed to the stockholders.

> "(3) *Court Holding Company.*—Your committee's bill eliminates questions arising as a result of the necessity of determining whether a corporation in process of liquidating made a sale of assets or whether the shareholder receiving the assets made the sale. Compare *Commissioner v. Court Holding Company* (324 U.S. 331), with *U. S. v. Cumberland Public Service Company*

---

[11] A leading Law Review comment on Section 337 states:

"The new provision contains certain limitations consistent with its purpose. Already mentioned is the requirement that the assets be sold within a period of twelve months after adoption of a plan of liquidation. While objections have already been made to the stringency of this requirement, it appears to be realistic and will give the taxpayer only one year in which to choose (by conforming or not conforming to all the requirements of section 337) recognition or non-recognition for gains or losses from sales. A longer period might be unfair to the revenues and difficult to police." Cohen, Gelberg, Surrey, Tarleau and Warren, "Corporate Liquidations under the Internal Revenue Code of 1954," 55 *Colum. L. Rev.* 37, p. 45 (January 1955).

(338 U.S. 451). This last decision indicates that if the distributee actually makes the sale after receipt of the property then there will be no tax on the sale at the corporate level. In order to eliminate questions resulting only from formalities, *your committee has provided that if a corporation in process of liquidation sells assets there will be no tax at the corporate level, but any gain realized will be taxed to the distributee-shareholder, as ordinary income or capital gain depending on the character of the asset sold.*" (Emphasis added.) H. Rep. 1337, 83d Cong., 2d Sess., 1954, pp. 38-39.

"Section 333 [337 in Senate bill] incorporates in the bill rules for treatment of the problem raised in the decisions of *Commissioner v. Court Holding Company* (324 U.S. 331) and *U.S. v. Cumberland Public Service Co.* (338 U.S. 341) and the numerous related cases. These decisions concern the question of whether the corporation or a shareholder effected a sale of property in connection with a liquidation. Under the decision in the *Cumberland Public Service Co.* case, supra, it is indicated that in the case of an actual distribution in liquidation of the corporation prior to an actual sale by the shareholders a single tax is imposed at the shareholder level. Accordingly, under present law, the tax consequences arising from sales made in the course of liquidation depend primarily upon the formal manner in which transactions are arranged. *The possibility that double taxation may occur in such cases results in causing the problem to be a trap for the unwary.*

"Your committee intends in section 333 to provide a definitive rule which will eliminate any uncertainty.

* * *

"*Subsection (a) accordingly permits the imposition of a single tax at the shareholder level upon property sold during the course of a liquidation* irrespective of whether the corporation or the shareholder in fact effected the sale provided the other provisions of this subsection are met. * * *" (Emphasis added.) H. Rep. 1337, 83d Cong., 2d Sess., 1954, pp. A106-107.

"(c) *Court Holding Company.*—Your committee follows the House bill in eliminating questions arising as a result of the necessity of determining whether a corporation in process of complete liquidation made a sale of assets or whether the shareholder receiving the assets made the sale. Compare *Commissioner v. Court Holding Company* (324 U.S. 331) with *U. S. v. Cumberland Public Service Company* (338 U.S. 451). This last decision holds that if the distributee actually makes the sale after receipt of the property, there will be no corporate tax on the sale. The result of these two decisions is that undue weight is accorded the formalities of the transaction and they, therefore, represent merely a trap for the unwary." S. Rep. 1622, 83d Cong., 2d Sess., 1954, pp. 48-49.

* * *

"Section 337 corresponds in function to section 333 of the House bill and concerns the problems raised by the decisions in *Commissioner v. Court Holding Company*, 324 U.S. 415, and *U. S. v. Cumberland Public Service Co.*, 338 U.S. 341, and the numerous related cases. These decisions involve the question of whether the corporation or the shareholder effected a sale of property in connection with the liquidation of the corporation. Under the decision in *Cumberland Public Service*

Co., supra, it is indicated that in the case of a distribution of property in liquidation of a corporation followed by its sale made in fact by its shareholders, a single tax is imposed at the shareholder level. *Where the shareholders in fact did not effect the sale, tax is imposed both at the corporate and at the shareholder level.* Accordingly, under present law the tax consequences arising from sales made in the course of liquidations may depend primarily upon the formal manner in which the transactions are arranged. Your committee intends in section 337 to provide a definitive rule which will eliminate the present uncertainties * * *." (Emphasis added.) S. Rep. 1622, 83d Cong., 2d Sess., 1954, p. 258.

There is a similar comment in the authoritative Law Review article above referred to:

"Section 337 of the new Code provides that if a corporation distributes all of its property (except assets retained to meet claims) in complete liquidation within twelve months after adoption of a plan of liquidation, no gain or loss will be recognized on sales or exchanges of property by the corporation during that twelve-month period. *This provision is designed to mitigate the impact of the dual system of corporate income taxation—a tax at the corporate level on corporate earnings followed by a tax at the shareholder level on distributions*—where the corporation, and therefore the basis for the dual tax, ceases to exist. * * *" Cohen, Gelberg, Surrey, Tarleau and Warren, "Corporate Liquidations under the Internal Revenue Code of 1954," 55 *Colum. L. Rev.* 37, p. 44 (January 1955).

Thus, Section 337 is intended to, and does no more than, eliminate double taxation of the income realized on sale of assets by a liquidating corporation—the tax at the corporate level is eliminated but the tax at the shareholder level is retained. In the language of the House Committee Report, *supra,* "if a corporation in the process of liquidation sells assets there will be no tax at the corporate level, but any gain realized will be taxed to the distributee-shareholder." For this reason Congress used the "not recognized" phrase in Section 337, rather than choosing the equally well known contrasting phrase that the gain "shall not be included in gross income" or shall be "exempt" from tax.

The gain here involved was of the nature which Congress wanted to tax. To "exempt" it from tax would be farthest from its mind. But its purpose was to provide for it being taxed once rather than twice. How natural then, to provide that such gain would not be "recognized" at the corporate level if it were immediately taxed at the shareholder level!

Further, the accuracy of the choice of the "not recognized" phrase by Congress, and the soundness of the ensuing result that Section 265 would not apply to such gain, are evident in a consideration of the results which would follow if the single tax result were obtained not by using Section 337 but by following the pattern approved by the Supreme Court in the *Cumberland Public Service Company* (338 U.S. 451 (1950)) case, cited in the foregoing Committee Reports, under which the corporation first liquidates

and then its stockholders sell the assets to the eventual purchaser. It is well settled that a corporation "realizes" no gain on the distribution of appreciated assets in such a complete liquidation. It is equally well settled, however, that the expenses as well as any taxes imposed on the corporation in making such distribution in liquidation are deductible without limitation. *Commissioner v. Wayne Coal Mining Co.*, 209 F.2d 152 (3rd Cir. 1954) (attorneys' and accountants' fees); *United States v. Arcade Co.*, 203 F.2d 230, 235-236 (6th Cir. 1953) (attorneys' and accountants' fees); *Pacific Coast Biscuit Co.*, 32 B.T.A. 39, 42-43 (1935) (A. 1954-1 *Cum. Bull.* 6) (attorneys' fees and depositary service fees); *Tobacco Products Export Corp.*, 18 T. C. 1100 (1952) (N.A. 1955-2 *Cum. Bull.* 11) (actually involving both New York transfer tax and Federal stamp tax on the transfer of assets in liquidation).

Although under such circumstances the gain to the distributing corporation on the appreciation of the assets distributed is not "realized", it is clearly established that the expenses and taxes relating thereto are deductible. Certainly there is nothing to indicate that Congress in granting the relief from double taxation provided in Section 337 intended to attach a penalty consisting of the denial of deductions relating to the sale which deductions were allowed if the *Cumberland Public Service* route were used. In fact, the Committee Reports above quoted indicate exactly the opposite—that Congress intended to permit a taxpayer to achieve the same result that could be achieved under the *Cumberland Public Service* route by fol-

lowing the more simple procedure of having the corporation make the sale followed by the liquidation. Congress enacted Section 337 to eliminate the artificial distinction between the two types of liquidation procedure and to remove a tax trap for the unwary. It is submitted, therefore, that a comparison of the tax results under Section 337, contrasted with those under the alternative *Cumberland Public Service* route, again demonstrates that the choice of the "not recognized" language by Congress is accurate and that the resulting non-applicability of Section 265 is in harmony with the law and congressional intent in this field.

Although no case has as yet been decided involving the application of Section 265(1) to a Section 337 liquidation, the case of *Cotton States Fertilizer Co.,* 28 T.C. 1169, decided by the Tax Court on September 16, 1957, is a case directly in point upon the question of whether "gain not recognized" constitutes income "wholly exempt" from taxation within the meaning of Section 265. The Commissioner has acquiesced in this decision. 1958-1 *Cum. Bull.* 4. This case involved the inter-relation of Section 112(b), Internal Revenue Code of 1939 (Section 1033, I.R.C. 1954) and Section 24(a)(5), Internal Revenue Code of 1939 (Section 265(1), I.R.C. 1954). The former section provides that no gain shall be *recognized* if property is involuntarily converted into other property. Two of the taxpayer's plants were destroyed by fire. The taxpayer carried fire insurance but in order to present its claims for insurance it employed architects to recreate plans and specifications and a contractor to estimate

the replacement cost of the destroyed plants. As a result of such claims the taxpayer recovered insurance proceeds exceeding its cost basis for the destroyed plants. The proceeds were used to replace the destroyed property and no gain was reported in accordance with Section 112(f). The taxpayer deducted the amounts paid the architects and contractor as business expenses but the Commissioner disallowed the deductions under Section 24(a)(5). The Tax Court held the insurance proceeds on which gain was not recognized under Section 112(f) were not income "wholly exempt" from taxation by reason of the taxpayer's election under the non-recognition provision. The Court stated:

> "Sections 22(b) and 116 list a great number of items which, according to these sections of the statute, 'shall not be included in gross income, and shall be exempt from taxation under this chapter.' Nowhere in these sections are proceeds from fire insurance listed as being exempt." (at p. 1172.)

Similarly, in our case, nowhere in the Code is a gain realized in a Section 337 liquidation listed as being exempt.

The legislative history of Section 24(a)(5) (predecessor to Section 265), which was added to the Code in 1934, shows that the situation which Congress intended to cover is the usual case of exempt income which is never taxed. Note the examples given of exempt income in H. Rep. No. 704, 73d Cong., 2d Sess., p. 23:

> "Section 24(a)(5). Disallowance of deductions attributable to tax-exempt income: This

paragraph has been added to the bill to eliminate as deductions from gross income expenses allocable to the production of income wholly exempt from the income tax. Under the present law *interest on State securities, salaries received by State employees, and income from leases of State school lands* are exempt from Federal income tax, but expenses incurred in the production of such income are allowed as deductions from gross income." (Emphasis added.) Seidman's *Legislative History of Federal Income Tax Laws, 1938-1861,* p. 315.

The types of income referred to in the Committee Report are the ordinary classes of income wholly exempt from tax—not non-recognized gains. Similarly, the cases have applied Section 265(1) only to the usual types of specifically exempt income. See cases referred to in 4 Mertens *Law of Federal Income Taxation* § 25.128; 60-2 CCH, *Federal Tax Reporter* ¶2226. The one case where non-recognized gain, rather than a class of specifically exempt income, was involved is *Cotton States Fertilizer Co., supra,* holding that non-recognized gains are not "wholly exempt income." Cases there cited by the Commissioner were distinguished on the ground that "they involve only life insurance proceeds which are made wholly exempt by statute."

B. SECTION 265 IS NOT APPLICABLE BECAUSE IT DISALLOWS DEDUCTIONS FOR EXPENSES BUT DOES NOT REACH ITEMS DEDUCTIBLE AS TAXES.

The deduction sought by Refiners here is not for any *expense* incurred in producing the gain on sale

of assets, but for the Hawaii net income tax assessed on account of the gain. We submit that this tax is not an expense allocable to tax exempt income within the scope of Section 265.

The heading of Section 265 is "*Expenses and Interest Relating to Tax Exempt Income.*" The subheadings are:

> "(1) *Expenses.—*
>
> "(2) *Interest.—*"

Such headings were not included in the 1939 Code (See Section 24(a)(5)), but their use in the 1954 Code indicates the intention of Congress—that is, Congress intended to disallow expenses of producing tax exempt income and interest on indebtedness incurred to purchase or carry tax exempt bonds.

The headings and subheadings used in Section 265 are entirely consistent with the intent of Congress in enacting Section 24(a)(5) in 1934:

> "* * * This paragraph has been added to the bill to eliminate as deductions from gross income *expenses* allocable to the *production* of income wholly exempt from the income tax. * * *" (Emphasis added.) H. Rep. 704, 73d Cong., 2d Sess., Seidman's *Legislative History of Federal Income Tax Laws 1938-1861,* at p. 315.

The Senate Finance Committee Report notes that "it is contended that under the existing law all *expenses incurred in the production of such income* are allowable as deductions" and that the House bill specifically disallows *expenses* of this character, and the

Senate Report recommends that there be no denial of deductions for "*expenditures* incurred in earning tax-exempt interest." (Emphasis added.) S. Rep. 558, 73d Cong., 2d Sess., *Seidman, supra*, at p. 315.

In the case of sale of assets by a liquidating corporation, necessary expenses of negotiating and concluding the sale, such as brokers' commissions, property descriptions, surveys and legal fees would be considered as expenses incurred in the *production* of the gain. However, an income tax on the profit derived from the sale can have no part in the *production* of the gain.

Important distinctions exist between the basic concepts of the deduction for expenses and the deduction for taxes. First, the deduction for expenses is essential to arrive at the net amount of income from a business or other income producing activity. Taxes, on the other hand, are a charge on the net result of that activity and, strictly speaking, need not be deducted in arriving at net income. Secondly, referring to the language quoted above from the Committee Reports, taxes are neither "incurred in" nor "allocable to" the "production of income."

The deduction for taxes in general enjoys a much wider scope than the deduction for expenses. Expenses may be deducted only where they are connected with a trade or business or with the production of non-business income. Sections 162 and 212. But a broad variety of taxes, which are connected neither with business activity nor with the production of income, are allowable as deductions. Section 164. These include

many sales taxes, real estate taxes, personal property taxes, etc. Section 265(1) provides a sensible caveat to the general rule on deduction of expenses but, applied to taxes, it would be irrational. If taxes related to non-taxable income are to be denied deduction, so too should taxes which are in no way related to the production of income.

An item may be deductible as a tax, it may be deductible as an expense, or it may be deductible as either. While the terms are not mutually exclusive, neither are they equivalent, and the fact that an item may be denied deductibility as an expense does not affect its deductibility as a tax. Any tax deductible under Section 164 is absolutely deductible regardless of the nature of the tax and regardless of the circumstances of its application. Thus:

(a) Fees payable by a corporation in connection with the issuance of its capital stock are non-deductible because they are considered as capital items. But if the exaction in question is not a fee but is a tax imposed upon such issuance, then it is deductible. *Holeproof Hosiery Co.,* 11 B.T.A. 547 (1928); *Borg & Beck Co.,* 24 B.T.A. 995 (1931) (A. XI-1 *Cum. Bull.* 2); *Logan-Gregg Hardware Co.,* 2 B.T.A. 647 (1925); *Commercial Investment Trust Corporation,* 28 B.T.A. 143 (1933), *aff'd* 74 F.2d 1015 (2d Cir. 1935).

(b) Prior to the Revenue Act of 1942, which severely limited the deduction for Federal stamp taxes, the Commissioner himself held that a Federal stamp tax imposed upon a sale of securities at a loss was fully deductible as a tax although under the statute, the loss itself was not deduct-

ible. G.C.M. 18245, 1937-1 *Cum. Bull.* 70. However, if the exaction in question under such circumstances was a fee rather than a tax, the deduction was not allowed. I.T. 3161, 1938-1 *Cum. Bull.* 116.

(c) If a contractor, in acquiring material for a building, pays a use tax imposed directly on him, and with respect to certain other material a sales tax is "passed on" to him by his vendors upon whom the sales tax is directly imposed, the latter must be capitalized, whereas the former can be deducted. *Joe W. Stout,* 31 T. C. 1199 (No. 124) (March 25, 1959) (A. I.R.B. 1959-48, p. 6).

The foregoing cases illustrate the difference between taxes, which are an absolute deduction irrespective of whether they relate to a capital transaction, and other expenses which are not deductible if incurred in a capital transaction. If taxes cannot be deducted as expenses because of the rule that expenses in a capital transaction are a charge against proceeds or because of Section 265, they may nevertheless be deducted simply as taxes.

Actually, Section 265 can never apply to expenses which are allocable to income from the sale of assets. Such expenses *qua* expenses are not "otherwise allowable as a deduction," as required by Section 265. As expenses, they are allowable only as offsets against the sale proceeds, not as a deduction from gross income. If no tax is imposed on the gain realized on the sale, the qualification of an item as an expense of sale does not produce any tax benefit. It simply reduces gain which is not subject to tax in the first

place. State taxes on the other hand are not applicable to reduce gain but are an absolute independent deduction under Section 164 (taxes).

In view of the well established difference between taxes, which are an absolute deduction, and other expenses, which are not deductible in capital transactions, Congress can hardly have been contemplating taxes when it enacted the predecessor of Section 265.

In the case of State income taxes, the argument is even stronger since such taxes are not available as offsets against gain on the sale of assets to begin with. According to the Committee Reports quoted above, Section 265 is designed to apply to "expenses incurred in the production of [tax exempt] income." State income taxes on the gain realized on a sale of assets can hardly be viewed as incurred in the production of such gain.

We recognize that the Tax Court has in five cases denied deductions for taxes under Section 265(1): *Mary A. Marsman,* 18 T. C. 1 (1952); *George W. P. Heffelfinger,* 5 T. C. 985 (1945); *James F. Curtis,* 3 T. C. 648 (1944); *Henry P. Keith,* T. C. Memo. 10883, 1 CCH Tax Ct. Mem. 184 (1942), *aff'd* on another issue, 139 F.2d 596 (2d Cir. 1944); and *Laurence B. Halleran,* B.T.A. Memo. 106736, 106737 (1942), 1942 P-H *B.T.A. Mem. Dec.* ¶42,456, remanded on another issue by 2d Cir. However, the argument made above was never presented to the Tax Court in the *Marsman, Heffelfinger, Keith* and *Curtis* cases. The point was made and rejected on very brief consideration in the memorandum decision in *Halleran,* but it has never

been passed on by a higher court. We believe that the Tax Court has repeatedly misinterpreted Section 265 by including taxes within its scope. We urge this Court, on full and original consideration of this matter, to correct this misinterpretation and properly delineate the scope of Section 265. Section 265 was intended to and does relate to expenses incurred in the production of tax exempt income; State income taxes are not such expenses.

CONCLUSION

Refiners was entitled to the tax deductions claimed by it in the years 1953 and 1955 for the Hilo Gas operating loss and Hawaii income taxes. On the first issue, the decision of the District Court ignores the facts; on both issues the decision of the District Court misinterprets the law. For the reasons set forth above, it is respectfully submitted that the judgment of the District Court should be reversed with respect to both of these issues.

Dated, Honolulu, Hawaii,
July 25, 1960.

Respectfully submitted,

Marshall M. Goodsill,
Attorney for Appellant.

Anderson, Wrenn & Jenks,
Of Counsel.